THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

MAY 22, 2003

Printed for the use of the Committee on Financial Services

Serial No. 108–30

U.S. GOVERNMENT PRINTING OFFICE

89–633 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chairman*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
DOUG OSE, California
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
PATRICK J. TOOMEY, Pennsylvania
CHRISTOPHER SHAYS, Connecticut
JOHN B. SHADEGG, Arizona
VITO FOSELLA, New York
GARY G. MILLER, California
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
TIM MURPHY, Pennsylvania
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
JAY INSLEE, Washington
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
RAHM EMANUEL, Illinois
DAVID SCOTT, Georgia
ARTUR DAVIS, Alabama

BERNARD SANDERS, Vermont

Robert U. Foster, III, Staff Director

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

DOUG OSE, California, *Vice Chairman*
CHRISTOPHER SHAYS, Connecticut
PAUL E. GILLMOR, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
EDWARD R. ROYCE, California
DONALD A. MANZULLO, Illinois
SUE W. KELLY, New York
ROBERT W. NEY, Ohio
JOHN B. SHADEGG, Arizona
JIM RYUN, Kansas
VITO FOSSELLA, New York
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
GARY G. MILLER, California
PATRICK J. TOOMEY, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
MELISSA A. HART, Pennsylvania
MARK R. KENNEDY, Minnesota
PATRICK J. TIBERI, Ohio
GINNY BROWN-WAITE, Florida
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

PAUL E. KANJORSKI, Pennsylvania
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
JAY INSLEE, Washington
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
RAHM EMANUEL, Illinois
DAVID SCOTT, Georgia

CONTENTS

THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK

Thursday, May 22, 2003

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance,
And Government Sponsored Enterprises
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:06 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [Chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Gillmor, Bachus, Oxley (ex officio), Kelly, Fossella, Biggert, Toomey, Hart, Tiberi, Kanjorski, Inslee, Capuano, Ford, Clay, Matheson, Miller, Emanuel and Scott.

Chairman Baker. [Presiding.] This meeting of the Capital Markets Subcommittee will come to order.This morning, we are here to examine not a new market mechanism, but one which has exhibited extraordinary growth over recent years, the hedge fund. To start with, there is not even a clear definition of what constitutes a hedge fund. Although hedge funds perform amazingly well, they are not necessarily linked to overall market performance. Hedge funds have demonstrated an ability to generate positive cash flow in a down or up market, which is a good thing. Hedge funds have also generated significant liquidity and helped to be a counterbalance to the risk prevalent in ordinary market functions, which is a good thing.

So our purpose here today is not to condemn the hedge fund concept, but merely to continue the committee's ongoing examination of all aspects of market function, which began almost three years ago. There is some expressed concern as innovation proceeds that the fund of funds becomes a methodology for the retailization of hedge fund risk, which certainly leads us to examine suitability requirements and the necessary transparency of disclosure of the risk undertaken by hedge funds so that even the sophisticated investor may properly examine the risk they are assuming with their investment. Beyond the initial disclosures made at the time of investment decisions, it is apparent to me that a continuing disclosure regime would also be advisable, given the nature of the hedge fund's changing its risk profile. Certainly, there should be examination of the standards for the management of the hedge fund. With the extraordinary growth not only in the nominal dollar amount, but in the numbers of hedge funds, as best we can determine what

they are, there is certainly an increased level of anxiety about the adequacy of management not only in disclosure, but in day-to-day governance of the risk assumed by their operation.

We also need to examine the current regulatory requirements for registration. Since the manager of a single hedge fund is not required under current rule to become a registered compliant entity with the SEC, therefore the manager of up to 14 hedge funds perhaps could not be subject to SEC oversight and examination, and whether that regime is appropriate in today's environment.

Having listed a number of concerns, certainly the function of hedge funds in today's market is a positive addition. We should do nothing that would bring, or at least in my opinion, hedge funds under day to day governmental regulation where we have someone from the SEC sitting on the board of every hedge fund. But I do believe it is appropriate to examine the risk they potentially could present, given their enormity, to systemic risk developments, and to further examine whether the individual investor truly understands the risks they may be assuming and whether the continued explosion of funds and the potential retailization brings those into the market who really should not be there.

I certainly appreciate those who will participate in the hearing this morning. I have read Chairman Donaldson's statement. I find it most helpful to the committee, and look forward to hearing from other witnesses who will come before us on the second panel.

At this time, I recognize Mr. Kanjorski for any statement he may choose to make.

Mr. KANJORSKI. Mr. Chairman, we meet today for the first time since our subcommittee considered legislation in 2000 in response to the collapse of Long-Term Capital Management, to explore the issue of hedge funds. Created more than five decades ago, hedge funds have largely operated on the periphery of our nation's capitalistic system, with limited regulatory oversight, restricted investor access, and little public disclosure. Nevertheless, hedge funds, in my view, have played an important and crucial role in the ongoing success of our capital markets.

Before we hear from the witnesses, it is important to review some basic facts about the size and scope of the hedge fund industry. Today, experts estimate that there are between 6,000 and 7,000 hedge funds operating in the United States. The hedge fund industry has grown substantially in recent years. According to several estimates, hedge funds managed $50 billion in 1990, $300 billion in 2000, and $650 billion in 2003. Moreover, although hedge fund holdings represent about 4 percent of the value of the stock market, the Wall Street Journal recently reported that hedge fund trading accounts are nearly one-quarter of the daily volume.

As our capital markets have continued to evolve in dramatic ways during the last decade, hedge funds have attracted the attention of many of our nation's investors, particularly those who want to earn higher returns in today's chaotic markets. Because of their entrepreneurial investment strategies and their independence of the legal requirements applied to other securities products, hedge funds can generate positive returns even during bear markets. Additionally, hedge funds have attracted the attention of our regulators.

In February, for example, the National Association of Securities Dealers issued a notice to brokers reminding them of their obligations when selling hedge funds. Last year, the Securities and Exchange Commission also began comprehensive review of a number of issues related to hedge funds, including their recent growth, trading strategies, regulatory oversight, and transparency.

In its investigations, the commission has also worked to examine the retailization of hedge funds. As my colleagues know, investor protection is a top priority of mine. From my perspective, a hedge fund is a very sophisticated securities instrument. As a result, only very sophisticated individuals with adequate resources and sufficient diversification should purchase this type of product for their portfolios.

Hedge funds have also successfully operated with little regulatory scrutiny for many years, and we should not now add additional layers of unnecessary regulation in order to further protect those investors who are truly qualified to make these investments and already fully understand the risks involved.

As we consider these issues, I would further encourage my colleagues on both sides of the aisle not to make quick judgments about changing the statutory and regulatory structures governing the hedge fund industry. Unless we identify something wrong, something that endangers our capital markets, something that poses a systemic threat to our financial institutions, or something that represents bad public policy, we should defer action in this area and await the recommendations of the experts at the Securities Exchange Commission and elsewhere. We additionally must move forward prudently and carefully in our regulation in these matters, in order to ensure that we do not cause further disturbances in an already turbulent capital market.

Finally, later this morning I expect that we will hear complaints about short-selling, a strategy used by a number of successful hedge funds managers. I believe that this practice provides investors with an opportunity to use the information that they have about a particular company, industry or financial instrument to make money. This practice, in my view, is therefore a useful investment technique. It also helps to provide needed liquidity in our capital markets. Furthermore, it is perfectly legal. In short, when fairly practiced, short selling is an important offshoot of capitalism and we should not necessarily limit the practice.

Mr. Chairman, I want to commend you for bringing these matters to our attention. I look forward to hearing from the witnesses, especially Chairman Donaldson, who is testifying before us for the first time since he took over the helm of the SEC. I look forward to his valuable insights and leadership, and congratulate you for having these hearings, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 57 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.Chairman Oxley?

Mr. OXLEY. Thank you, Chairman Baker, and welcome, Chairman Donaldson, to the hearing. We are pleased to have him and certainly pleased to have him on board at the SEC.

The growth of the hedge fund industry makes it incumbent upon this committee to examine whether there are sufficient investor

protections currently in place. Pursuant to the committee's ongoing efforts to restore investor confidence, we are reviewing the financial products in our marketplace to ensure that investors are being treated fairly and appropriately. Some have argued that hedge funds are not an appropriate investment for retail investors. Others suggest that all Americans should be given access. Some have raised concerns about the lack of transparency in this industry, given its size, scope and impact on the markets.

Our review of this industry will help us determine whether additional regulatory scrutiny is warranted, or whether additional regulations would actually harm investors and the markets. Indeed, hedge funds have served their investors well throughout the recent bear market. The average hedge fund has recorded impressive gains in these difficult markets, and done so with less risk than the average mutual fund. The industry has experienced considerable growth over the past decade, increasing in size from approximately $50 billion in assets to about $600 billion today.

In just the past five years, the number of funds has doubled, with about 3,500 new hedge funds opening for business. This explosion in growth has been fueled by good performance and a growing interest from large institutional investors, pension funds, charitable foundations and university endowments.

Concerns have been raised that many financial services companies trying to capitalize on the exceptional performance of hedge funds have begun to market portfolios of hedge funds to retail investors. These funds of hedge funds are registered investment companies that typically invest in 20 to 30 hedge funds. They usually require lower minimum investments than traditional hedge funds. It is my understanding that these financial products available to institutional investors for some time are only being sold to investors who meet the income or net worth requirements of traditional hedge funds.

While hedge funds are currently being sold only to accredited investors, it is my understanding that the funds of funds are only doing so because they do not wish to sell to retail investors. There may be a concern that, given the lack of a statutory restriction, they could in the future change their guidelines and sell to retail investors. I look forward to learning from Chairman Donaldson what the commission has found thus far regarding the access to hedge funds by these investors.

Some question why retail investors are being denied access to these important financial risk-balancing tools simply because they are not wealthy. Today's panel will help illuminate this debate. Some have raised concerns about short-selling and its potential use to manipulate the market. I am pleased that the commission is examining these issues in its ongoing review of hedge funds in the markets, and look forward to hearing the views of Chairman Donaldson and our other witnesses on the effectiveness of existing laws prohibiting such activity.

I applaud the SEC's year-long review of hedge funds, and eagerly await the forthcoming staff report. There are many important investor protections and capital formation issues to be addressed. This committee and the commission must proceed with an abundance of caution as we examine this industry which has served its

investors well and provides important benefits to the markets. I am pleased, Mr. Chairman, to have this hearing and look forward to participating. I yield back.

Chairman BAKER. Thank you, Mr. Chairman. We appreciate your participation.Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman. I want to commend you for holding this important hearing on the role of hedge funds and their role in the financial markets. I would also like to thank Chairman Donaldson and our other distinguished witnesses. I have had a longstanding interest in this subject of today's hearings, going back to my service in the White House when the Long-Term Capital crisis occurred, and subsequently as an investment banker in the private sector. Last week, I had the opportunity to attend the SEC's roundtable on hedge funds. Chairman Donaldson and his team put together an excellent program by gathering a wide spectrum of the industry's participants and observers. We in the Congress also have a responsibility.

As Chairman Donaldson said, take a long hard look at hedge funds, especially in view of the industry's rapid growth, the increase in hedge funds' share of overall market trading volume, a spike in fraud cases, and the retailization of hedge fund products.

As this committee begins to gather information on the hedge fund industry, there are some fundamental questions we need to have addressed and begin to think about: to what extent is retailization of hedge funds a real problem; should the SEC require clear disclosure that address certain basic investor protections such as conflicts of interest, valuation, performance reporting, relations with crime brokers, and other service providers; should Congress and the SEC be focused on distinctions between accredited investors and ordinary investors; is the recent spike in hedge fund fraud cases the result of a few bad actors or is this a sign of widespread abuse.

Finally, I would like to hear from the panel on systematic risk issues. As hedge funds' share of the market's overall trading volume increases, now more than 25 percent of all trades, what unique risks are posed? Additionally, has market surveillance by regulators and counter-parties improved enough since Long-Term Capital? Clearly, many hedge funds and fund of hedge funds have historically served their investors well and have made positive contributions to the market. Many hedge funds are non-correlated with equity markets and thus reduce portfolio risk while providing diversification. But it is critical that investors, particular retail investors and pension funds, receive the information they need to be able to assess risk, make informed decisions, and evaluate their investments on an ongoing basis.

I have the largest number of Illinois police, firefighters and teachers from the Chicago police, firefighters and teachers, and I am concerned that the current disclosure scheme may not be providing pension managers with adequate information. This is especially important in light of the fact that many pension funds now invest upwards of 5 percent of their capital in hedge funds. With the prolonged downturn in the market, we also have retail investors flocking to hedge funds to try to make up for lost returns.

Therefore, if hedge funds are going to be accessible to retail investors and pension funds, and are going to be marketed to those parties, it seems to me that we seem to set some standards, not necessarily to restrict investor access, but to provide information in plain English to help people make good decisions.

I also think that hedge fund managers should be held to the same lock-up periods and trading restrictions as funds of other investors. I am eager to continue working with my colleagues and the SEC to ensure that investors receive the information they need to make informed investment decisions. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, sir.Mr. Toomey?

Mr. TOOMEY. Thank you, Mr. Chairman. I would like to just briefly observe, I think it is useful to think of hedge funds as an asset class unto itself; one that allows investors to diversify their portfolio, and certainly historically earn superior returns relative to the risk that they take. It is also important to note that the nature of the trading and investment strategies of many hedge funds actually adds a refinement to the pricing mechanism in the marketplace, and makes financial markets in particular more efficient. To achieve those things, they often employ confidential and proprietary trading strategies which are a necessary part of the business and entirely appropriate.

So I would just hope that as we explore this industry and learn more about its growth and the implications of that growth, that we bear in mind the significant benefits that this industry provides to investors, as well as to the efficiency of the marketplace.I yield the balance of my time.

Chairman BAKER. Thank you, Mr. Toomey. Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. I want to thank Chairman Baker and Ranking Member Kanjorski, and certainly welcome you, Chairman Donaldson, to this hearing today on hedge funds.Because hedge funds do not typically register with the government, the data on the industry is not entirely precise. For the past year, the Securities and Exchange Commission has conducted an investigation of the hedge fund industry, and the commission's report will be released later this year. I certainly look forward to today's hearing as a good learning opportunity that may show or may not show the need for greater disclosure by hedge fund investors.

I do think that we must move with caution. We do have to determine what measure of oversight is needed, what is the level of investment risk. I think there should be questions possibly on possible conflicts of interest. There certainly have been questions raised about questionable marketing tactics. My understanding is that the Securities and Exchange Commission has brought 26 enforcement actions since 1998. However, 12 of those actions have been in the last year.

I think there may be some questions on the economics of the buyers, whether they have to have a certain amount of minimum wealth; should that be stated and regulated. I think it is an understanding that those who buy in the hedge funds should have certainly a minimum of $1 million in assets, or certainly at least $200,000 that have been accumulated in income each year. I think that raises a question, is this only a wealthy person's game? Is

there room for more players at various levels of the economic spectrum, and if that a wise thing for them to do.

I think also that one in five hedge firms have closed, certainly, in the last year after losing money through possibly poor decisions. But according to a recent study, 15 percent of those were due to sort of scam operations. So I think that there is evidence in dealing with hedge funds that we certainly need to look at them. They have certainly been very positive in many areas, but it is certainly an excellent opportunity for us to take a good look at them and hear from you to determine what recommendations you might offer this committee as we move forward.

I certainly want to thank this panel for your testimony today, and thank you, Mr. Chairman, for having this hearing.

Chairman BAKER. Thank you, Mr. Scott.Mr. Bachus?

Mr. BACHUS. Secretary Donaldson, I want to praise you on another matter. You recently criticized the inclusion in the new bankruptcy act of watering down the disinterested rule as it pertains to prohibiting former investment bankers from acting as advisers to the bankruptcy trustee. That is a safeguard we have had since 1938, and I appreciate your testimony in the Senate saying that this is not the time to start watering down conflict of interest rules. I just want to commend you for that.

I had actually offered an amendment here in the House to strike that provision. To reinforce what you said, the national bankruptcy review commission unanimously agrees with you that that would be unwise. It certainly would not restore integrity to the markets or confidence in the markets. I commend you for taking that position.

Chairman BAKER. Thank you, Mr. Bachus.If there are no further members desiring to make opening statements, at this time it is my distinct pleasure to formally welcome the Chairman to our committee. I am certain that over the coming months and years, we will have a very beneficial working relationship. I am particularly pleased by your already-demonstrated leadership skills. So it is my pleasure to welcome to Capital Markets Subcommittee the Honorable William H. Donaldson to make whatever comments he may choose to make.

Welcome, sir.

STATEMENT OF HON. WILLIAM H. DONALDSON, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. DONALDSON. Chairmen Baker and Oxley, and Ranking Member Kanjorski and members of the subcommittee, thanks very much for inviting me to testify to discuss hedge funds generally and the Securities and Exchange Commission's ongoing fact-finding review of hedge funds.

As you all know, last week the commission hosted a two-day roundtable on hedge funds. The event was a great success, in our view, and proved to be very informative and very lively. There was a great public interest in the event, both in the number of people who attended and those that listened on the Web cast. This public interest highlights just how important hedge funds have become. The roundtable was an excellent example, in my view, of how the SEC can operate as an effective regulator.

By assembling a highly knowledgeable group of experts representing a variety of viewpoints, we were able to facilitate a debate on the important issues facing hedge funds, many of which you have alluded to just a few moments ago. I appreciate having the opportunity to discuss the roundtable and our fact-finding review of hedge funds with you today.

As you know, the commission embarked on a fact-finding mission last year to look into hedge funds. The commission's division of investment management, alongside of our office of compliance, inspections and examinations, has been gathering information on a variety of investor protection issues associated with hedge funds. The staff obtained and reviewed documents and information from many different hedge fund managers representing over 650 different hedge funds and approximately $162 billion under management. The staff also visited and engaged in discussions with a number of different hedge fund managers. To complement our inquiries directed to specific hedge funds, the staff has met with a variety of experts, consultants, academics, and observers of the industry to seek their perspective. Participating in last week's roundtable were hedge fund managers, consultants, service providers such as auditors and attorneys, academics, prime brokers, investment bankers, investors and foreign and U.S. regulators.

These experts discussed key aspects of hedge fund operations, how they are structured and marketed, investment strategies that they use, how they impact our markets, now they are regulated, and whether the regulatory framework should be modified. Specifically, we had discussions that addressed, number one, the growth of hedge funds; number two, the hedge fund trading strategies and market impact; number three, trends in the hedge fund industry; four, the differences between hedge fund and registered investment companies; five, hedge fund fraud; and six, the regulatory framework applicable to hedge funds; and seven, investor education.

Many people have asked why the commission determined to embark on its fact-finding mission at this particular moment. One of the primary reasons is because of the tremendous growth of the funds. Over the past few years, the number of hedge funds and their assets under management has continued to increase. As was reiterated last week at the roundtable, there are no precise figures, which is an indicator itself of a lack of knowledge available regarding the number, size and assets of the funds.

This is due in part to the fact, and this I think is an important point, that there is no industry-wide definition of a hedge fund, in part because those that track hedge fund data rely on self-reporting by hedge funds, and in part because hedge funds generally do not register with the SEC. So we cannot independently track the data. Nevertheless, during our roundtable, knowledgeable sources confirmed their belief that there are between 6,000 and 7,000 hedge funds. I read in this morning's paper that another person thought that there were somewhat fewer than that; another expert source. The 6,000 to 7,000 have roughly $650 billion under management. Over the past few years, the panelists estimated that there have been on average $25 billion a year in new assets invested in hedge funds. One panelist estimated that in the next decade, assets under management in hedge funds will top $1 trillion.

Institutional investor money, be it from pension funds, endowment, or foundations or other sources, account for an increasingly large percentage of these assets.

The commission has made significant progress in its hedge fund fact-finding mission, and we will continue to proceed with a focus on how to best protect investors and our securities markets. Additionally, we have called for public comment on the issues surrounding hedge funds. The public comment period will close approximately 45 days from today, on July 7. I view this as an important next step, as we will need to hear from all segments of the hedge fund industry, including those not represented at the roundtable, as well as those of the investing public. While we had many distinguished, thoughtful and helpful panelists, I am mindful that in such a public forum as a roundtable, we may have heard a guarded version of the state of the industry. It is our duty as the investor's advocate to ensure that we have all of the relevant information as we formulate a course of action.

So while the roundtable was not the culmination of our fact gathering, and though we have not yet reached any conclusions, I have asked the SEC's staff to prepare a report to the commission on the current results of our various fact-finding efforts. The report will be delivered to the commission and I intend to make it publicly available shortly thereafter. I anticipate the report will address the key issues that have been a focus of our inquiry, including hedge fund trading strategies and market impact, the increased availability of hedge fund exposure to retail investors, the disclosures investors receive when investing in hedge funds, and on an ongoing basis the difference between hedge funds and registered investment companies, conflicts of interest including those created by the fee structures of hedge funds and funds of hedge funds, the role of primary brokers, hedge fund fraud, the regulatory framework applicable to hedge funds, and last and certainly not least, investor education.

I have asked the staff to include in its report any recommendations for change in the regulatory framework governing hedge funds. I look forward to reviewing this report, analyzing the recommendations, and sharing the report with you.

Thanks again for the opportunity to be here this morning. I would be more than happy to answer any questions you might have. Thank you.

[The prepared statement of Hon. William H. Donaldson can be found on page 59 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman. I took time to carefully review your written testimony, which I found to be very helpful. The point upon which I have set most attention is that the management of the hedge fund may count a hedge fund as a single client, and under current rule until you have more than 15 clients, you are not required to register. Therefore, you do not really have the regulatory ability today to tell us who are these people that have entered into the market within the last few years, and their level of expertise in the management of these funds, which is cause for two further observations. One, with regard to the issue of retailization, which I still believe is minimal at this juncture, given the $200,000 income rule for two years, and a net worth of $1 mil-

lion. That may need to be reviewed, and whether or not we are really seeing unsophisticated investors move into this market niche.

But secondly, on a broader national scale, whether the significant growth in numbers and in assets under management, which you reference at this point and estimate at about $650 billion with an eye toward $1 trillion; the potential systemic risk, given inappropriate or sideways movement in these markets, without prior knowledge by the regulatory community. That is of significant concern to me.

Another notch down on the scale, but still of significant concern, are those statements where short-selling activities appear not to be under the same regulatory scrutiny in the hedge fund world as it would be in the equities market, and the potential adverse volatility consequences that may bring about to the orderly function of the markets.

Do you think it now advisable based upon the work to date that we at least ought to have management get a driver's license? We may not regulate how big a truck or how much horsepower, or how fast they drive or where they go, but at least shouldn't we know who they are so if we do need to find them, we have got that information? How do we bridge not getting in the business, with having adequate information to assess the risks for the public good?

Mr. DONALDSON. Right. Well, let me say a couple of things. First of all, I do not want to pre-judge the vast amount of data that we are bringing to bear on the subject right now. I do not want to speak for the commission, if you will, because ultimately the responsibility will rest there. But let me try and answer your question. Whether it is 6,000 or 7,000 or whether it is $600 million or $600 billion, that is a lot of money.

Chairman BAKER. It is a lot.

Mr. DONALDSON. And it is too much money for us to know as little as we know now about what is going on. I mean, fundamentally I would say that. Secondly, the regulations that are currently in force are confusing, and I will not bore you by going through all of them, but the funds are operating most of them under exclusions under the Investment Company Act and other exemptions under the 1933 and 1934 Acts. It gets confusing in terms of which exemption or which exclusion they are operating under. I think it says to us that we have got to take a hard look at these exclusions.

If I can step back from that, and say that there are two trends going on here that were brought out at our conference and we are very much mindful of. First is that by and large, we have regulated hedge funds in so far as we have been able to regulate the registered ones, based on the assets and earning power of the purchaser. I think that calls into question whether that is the correct measure, because if you step back from the fluctuations that we have had in the marketplace, there is a perception, and it is probably more than a perception, that the hedge funds have fared better generally than our markets have, and generally than stocks have. There are a lot of "retail investors" out there who are pretty sophisticated, and who want to own hedge funds. So you have that on the one hand, and the statement is, why should only wealthy people have access to investment vehicles such as this?

On the other hand, you have the counter-trend which is that the exceptions under which the hedge funds have been operating do not reflect if we were to measure them by current dollars, there are an awful lot of "retail investors," if you will, or smaller investors who have moved up into this category. The question is, should the category be even higher in terms of exclusion, if that is going to be the criteria by which you let people in or out of hedge funds? So those two trends open Pandora's box in terms of what we should do about it.

And then the arrival of the fund of funds concept; the fund of hedge funds concept brings now, and that is a reflection of a demand in the marketplace. You have now registered vehicles, or vehicles seeking to be registered who themselves invest in hedge funds. Although they are voluntarily urged by us, restricting the kind of retail investor that can invest. In other words, that they are applying voluntarily, although they do not have to, because the parent company is registered doesn't have the exclusion, that they are basically voluntarily now limiting the size of an investment in these kinds of fund of funds. The problem is that the underlying investments, the underlying hedge funds themselves, most of them are not registered. We have no access to them. We cannot get inside of them. That is bothersome.

I do not know whether that answers your question, and I do not want to pre-judge exactly what the commission will be doing in this area.

Chairman BAKER. If I may, because my time has expired, it is clear to say that we need to know more. We are just not in a position today to establish what should be on the list to be identified in the way of detailed information until we do more examination.

Mr. DONALDSON. My instinct, my personal instinct based on everything that I have heard is that we need to one way or another know more about this phenomena, if you will.

Chairman BAKER. Thank you, Mr. Chairman. Mr. Kanjorski?

Mr. KANJORSKI. Have you seen any indications of fraud or abuse of any large amounts that would warrant the Federal government getting involved further in this issue? Or is it just curiosity on the part of the commission?

Mr. DONALDSON. Which issue, congressman?

Mr. KANJORSKI. On hedge funds; the activities, who is in them, what they are investing in, what they are doing.

Mr. DONALDSON. Again, there are, as was mentioned earlier, we have brought enforcement actions, and although they are relatively few; I mean, there are 25 or so enforcement actions that have been brought over the last three or four years; but over half of those have been brought in the year 2002. Those enforcement actions cover a range of things; hedge funds cannot advertise under our current laws; there are all sorts of things that these people were doing that we have brought action.

However, if you look at the total number of hedge funds, 25 actions is not that much. If you look at the number of actions, if you will, that we bring in the whole mutual fund industry, and imputed that to this industry, you would say that there were more actions out there that needed to be taken. That is a leap of judgment on

my part, and we need to know more about what is going on inside some of these funds.

Mr. KANJORSKI. What time frame do you see arriving at a definition of what a hedge fund is? It seems to me quite a challenge.

Mr. DONALDSON. I am not sure we will ever come up with a definition that is broad enough or meaningful enough. As you know, the whole hedge fund concept started many years ago, and it was quite simple. They are quite simple, and the idea was that instead of just buying and going along with stocks that you liked, why not at the same time sell stocks short that you did not like. That spreads your research effort, if you will. You go down a pike and look at a company you decide you do not like, and as a matter of fact you think it is overpriced, why not short that at the same time you are buying something that you like. That was a pure hedged vehicle, and the combination of being made sort of market-neutral, if you will, where no matter where the market went, you were balanced here with a long and short position, allowed borrowing to be inserted on top of that; leverage.

Now, as time has gone on, the term "hedge fund" applies to all sorts of investment techniques; macro techniques to commodity funds to pools of capital that are doing all sorts of things. I think that too often the word "hedge fund" is applied to a freestanding pool of capital that is not hedged at all; that is doing lots of different things. I think we need to know more about what those things are. We get at that, and this is probably a subject that you may want to get into, if there is some sort of market manipulation, if you will, associated with those techniques, we have the right right now to go at market manipulation and fraud in the marketplace. If it is out there, some of it is out there outside of hedge funds.

It is not a new phenomenon that people try to manipulate the market. Hopefully as our human resources increase at the SEC, we are going to be able to be much more broadly involved in uncovering that.

Mr. KANJORSKI. You are interested in that issue, I assume, Mr. Donaldson?

Mr. DONALDSON. Absolutely.

Mr. KANJORSKI. Do you think the Congress should get off its duff and act as soon as possible to give you that authority to get more people?

Mr. DONALDSON. To go one step further, the modern age we live in, and in particular the Internet, ups our challenge many-fold in terms of, you know, there are prohibitions on hedge funds from advertising, as long as they are operating under the exemption. A part of the exemption is they cannot advertise. There are obviously prohibitions on market manipulation. However, we have the Internet out there, and we have a whole new communications media, and we have a special group of people in the SEC now that are looking at the Internet as a source of possible market manipulation. But it broadens the scope of what we have to look at.

Mr. KANJORSKI. Just one other question; myself, I will sort of go with the rule that the we get the least involved we can, except for either trying to protect against systemic risk or fraud and activities that may be going on that we discover, but apparently, we have not

discovered that to a large extent. I am worried about the insured institutions that are providing some of the lending to these hedge funds. Have you had adequate reporting and has the regulators of these insured institutions received sufficient information to have a pretty good handle on just how much of the insured deposits are being placed and used by hedge funds? I guess another way of asking the question, are the $650 billion; what portion of that is coming out of the banking system or the insured system?

Mr. DONALDSON. I think that, you know, if the question you are asking is, do we have adequate resources now, human resources, inspection resources and so forth; I think we are headed toward that, if we can implement the authority that has been given to us and add the people that we want to add. I think that the evidence so far is that we do not see the broad gauge manipulation as the image is out there.

That is not to say that it is not there, and I do not want to make a judgment on that. As I said earlier, and I want to emphasize this, that if you took the general tenor of the conference we had a week ago, it was rather reassuring as far as I was concerned. Just trying to make an overall judgment, it was rather reassuring. On the other hand, we did not expect people that were possibly doing things that we think violate the law to come and talk about that in an open forum. So I want to assure you all that we are not stopping with just the two-day forum we had.

Mr. KANJORSKI. When your report is concluded, would you recommend that the committee have another hearing to receive your report, your analysis and conclusions on it, and any recommendations you may have for legislation?

Mr. DONALDSON. We would be absolutely delighted to sit down with you all and as a first step give you what we have. We will give you what we have with our recommendations, and I have no idea what those recommendations will be, but we certainly would want to explore them in any forum that you think makes sense, particularly this one.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman. By the way, happy birthday to the Chairman. Our crack staff gave me that information. I assume it is accurate.

Chairman BAKER. I am taking it regardless.

Mr. OXLEY. Okay.

[LAUGHTER]

Chairman Donaldson, the recent changes in the law in the Congress as well as at the SEC and the SROs have dealt with the manner in which analysts are evaluated and compensated in order to eliminate conflicts of interest between their desire to serve two masters; the corporate clients and retail investors. I think we are making some progress on that issue.

If an analyst were to issue a research report that does not reflect his own personal views of the covered security, that would be indeed a violation of the recent rules, is that correct? We have heard concerns that some analysts have been pressured to downgrade companies in order to curry favor with short-selling hedge funds that happened to be an important client for the analyst's firm, gen-

erating millions of dollars in revenues. That also would be a violation of the current laws and regulations, is that true?

Mr. DONALDSON. Yes, it would.

Mr. OXLEY. Could you tell me, is there any effort by the commission to investigate and take action against this type of abuse?

Mr. DONALDSON. We are particularly interested right now on the follow-up to the settlement. Okay? We have put some rules and regulations in and we are not going to just let it sit there. We are out in the field and making sure that there is conformity. Obviously, one of the aspects of the settlement and so forth has been the signing of the analyst's report and the analyst pledging that this is his or her view. The instance that you bring up has not been brought to my attention. That does not mean that we are no looking at it, but we would respectfully request that any sort of information like that be brought to our attention and we will do something about it. I just want to assure you that that would be a fraudulent act; what you cite there.

Mr. OXLEY. And that would be in the province of your enforcement division?

Mr. DONALDSON. Yes.

Mr. OXLEY. Thank you. In light of yesterday's press accounts, I would like to get your views on the practice of revenue sharing, whereby brokerage firms are paid by mutual funds for distribution. Without commenting on whether the agency is currently investigating this practice, I would like to have your views on the following: whether these payments are appropriate; whether you think investors are aware of this practice; and whether such payments should be disclosed to investors.

Mr. DONALDSON. Right. Let me just go back to your prior question, and just clarify that we would pick up what you talked about in terms of an analyst not performing according to the law. We would pick it up on the inspection side of the SEC. If we found evidence of that, we would turn it over to our enforcement people, but we would have our inspection people especially aware of the possibility of it. In terms of the mutual fund question you bring up, we are currently looking at the sales practices of mutual funds within the broker-dealer community to begin with.

What we are concerned with is there are laws that govern special incentives that are not disclosed to the sellers of mutual funds. We are concerned and therefore out investigating as I speak now the various practices and whether these practices are either violating the laws that exist now or violating the spirit of the laws that exist now. Our bottom line goal is to assure that a potential mutual fund investor through an investment banking firm is aware of all the compensation or inducements that are being paid to the broker that is selling them, not only to the broker, but to the broker's manager.

Mr. OXLEY. How much of that is currently revealed?

Mr. DONALDSON. I am sorry?

Mr. OXLEY. How much of that information today is currently revealed to the shareholder?

Mr. DONALDSON. I would say not enough. I would say that the average; there is disclosure, but I think that there are more subtle ways of incenting brokers to sell particular funds that the pur-

chaser does not know. I am leaping ahead of the work we are doing now to document that, but that is my own personal opinion and the reason for us being out in the field right now examining that.

Mr. OXLEY. Do you think a revenue-sharing arrangement is a conflict of interest on its face?

Mr. DONALDSON. What kind of——

Mr. OXLEY. The revenue-sharing agreement; would you consider that to be a conflict of interest simply on its face?

Mr. DONALDSON. At the very least, it is a piece of information that a prospective buyer has a right to know. A prospective buyer, in my view, has a right to know what incentives lie behind a recommendation. I believe that that is what we are after.

Mr. OXLEY. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Chairman. Mr. Scott?

Mr. SCOTT. I would like to kind of carry that thought just a little further, and talk about mutual funds and the hedge funds. I think it is true that brokers, prime brokers and advisers can manage both hedge funds and mutual funds. I would like to ask you to respond to that in terms of whether that is a possible area of conflict, particularly in view of the fact that over the last period of time, I think there has been an 11 percent increase in the profits accrued from hedge funds, and almost an identical 11 percent loss in the return on mutual funds. That in relationship to the conflict of interest; I mean, that almost begs for some examination. Then I have a follow-up question, but I would like you to respond to that one first.

Mr. DONALDSON. It is a very good question, and I think that clearly the hedged vehicles generally speaking have done better than unhedged vehicles, long-only mutual funds during a period of market decline. That is not to say all hedge funds have done better, but on average they have done better than on average what mutual funds have done. This creates an environment in which I would imagine there is considerable pressure in certain mutual fund organizations to have a line of products of hedge funds.

There is consumer demand out there. The conflict, if I understood your question correctly, there is always a potential conflict in a mutual fund family as between the various funds they are running, in terms of who buys first and that sort of stuff. That is pretty darn well regulated right now. But if in fact the laws were changed to allow the fund of funds concept to move into the mutual fund family, that again opens up a potential for conflict. So you would not do that quickly, but as I said earlier, I think there is a demand for hedge funds, and that is quite natural that it is coming at a time when long-only equity investing has been through such a difficult period.

Mr. SCOTT. Do you think that, if I am correct, that they have the right, the managers, to manage both of those funds and yet also operate under privacy? Do you feel stripping them of that privacy right would open up and make it——

Mr. DONALDSON. I think what you are asking, I think, is I think we need to know more than we do about what is going on in the general area of hedge funds. I think the place where one would question whether we should go to, and I would have personally serious questions, is whether the funds are under an obligation to

disclose exactly what they are doing, because that is a proprietary competitive fact. I think any attempt to display that would be counter to principles of people being able to build a business based on a special expertise. This is where I think we have to be very careful in terms of regulating the actual techniques being used.

Mr. SCOTT. Let me ask you this other question. Do you believe that smaller investors will be able to participate in similar activities in the future of hedge funds? Do you believe that hedge funds will remain what it is right now, essentially an investment tool for more wealthy individuals? Is it possible or are there efforts to try to open it up so that more middle class Americans would be able to benefit from this?

Mr. DONALDSON. I would say two things. One is I think there is a definite need to examine how hedge funds, properly run and properly disclosed, can be allowed to be purchased by retail investors, number one. I think number two is that there is a danger here that because of the particular market circumstances that we have had, and the relative performance of the stock market long-only mutual funds versus the hedge funds, that a tremendous new amount of money comes in, and as the new money comes in, the opportunities to operate in that niche profitably probably become less and less, so that the hedge fund returns, perhaps, are not quite as great as they have been in the past, or won't be. I think we have to guard against that in terms of the rapidity with which we examine opening funds up to lesser investors, to retail investors.

Chairman BAKER. Can you wrap up?

Mr. SCOTT. Thank you.

Chairman BAKER. Thank you, Mr. Scott.Mr. Toomey?

Mr. TOOMEY. Thank you, Mr. Chairman. Chairman Donaldson, I guess my question has to do with the additional information that I understand you to be suggesting I think intuitively that you feel you ought to have. My question is, you know, since we have an industry here where there is limited access, really it is by and large for the most part it is high net worth individuals. We have got very few cases of fraud. We have got an industry that is contributing to market efficiencies and providing superior returns to investors. Since there is a cost of complying with any new regulatory regime, there is a cost to providing information, I guess I am wondering what is the harm that is being done that warrants demanding more information or regulation, or what is the danger that you are worried about that would justify creating a new demand on an industry, which would of course have to pass that cost on to its investors?

Mr. DONALDSON. Yes, it is the old cost-benefit analysis that needs to be done. Clearly, I think what I am suggesting, and again this is my own personal view, is that the minimal level of gaining a right to examine hedge funds is not that costly, and the benefit to our society would justify that. It is what comes from that that is the big question. I make no judgment. All I can say is that we just do not know now what we do not know, if you will. I think that if what you are suggesting is do we need a huge new overlay of regulation, I just do not know. I doubt it right now, but we need to get the information to see whether we do.

Mr. TOOMEY. I guess that leads to another question, then. What kinds of things would you want to know that would be useful in terms of; I guess there is a concern that maybe something we do not know is out there that poses some kind of systemic risk to our markets or some significant risks that investors do not understand. I think most investors know that there is inherent risk in this kind of investment. I am trying to figure out what kinds of information would help in preventing those sorts of things, without undermining what you I think quite rightly recognize as the necessarily proprietary nature of the investment strategies.

Mr. DONALDSON. There are, again, for a large portion of hedge funds, we do not have the right to go in and take a look at what they are doing. So what would we be looking for when we go in and look at what they are doing? We would be looking at their books and records; we would be looking at the way they value securities. Again, if I am running a fund of funds and I have in my portfolio a hedge fund, and that hedge fund has to be valued on a quarterly basis or a monthly basis, how are those valuations being made? Those are the kinds of information that I think we need to take a look at. Books and records and the way the hedge fund is organized; all of these things we just do not know and we do not have the right right now to go in and look.

Mr. TOOMEY. Now, financial institutions that extend credit to these funds, they do undertake that kind of analysis. Or do you think that they do an inadequate job of understanding the answers to those very questions, so that they can make an informed credit judgment about the hedge fund?

Mr. DONALDSON. I think there has been substantial improvement in the responsibility and oversight of the prime brokers. They have a vested interest in that. They are lending money and so forth and so on. On the other hand, the funds are very good customers of theirs. So it is hard to tell exactly what is going on inside some of these funds. We had one of the largest investors at our conference, a major investor who one would think, who is a large purchase of hedge funds, and the question was asked, you must have buying power so that you can get inside some of these funds and ask questions that even a regulator cannot before you make an investment. The answer was, we have difficulty getting the information from a lot of these funds. Again, my supposition here is that the funds with very good records, that is the one that a fund of funds would want to buy, but everybody wants to buy it and so the fund says, we are not going to tell you. You can buy our fund or not. That forces the investor, the institutional investor to go to lesser funds with lesser records.

I guess what I am trying to say is that even those who have the market power to demand more knowledge about what is going on in funds that they want to buy are having trouble getting that; at least that is the partial evidence that we are getting right now.

Mr. TOOMEY. Thank you.

Chairman BAKER. Thank you, Mr. Toomey.Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman. I, too, want to wish you a happy birthday, just so it is bipartisan in its approach.

Chairman BAKER. I take it in that spirit. Thank you.

[LAUGHTER]

Mr. EMANUEL. To try to follow up on what my colleague was asking, but from a different side, we have mentioned that hedge funds have about $600 billion now in the market, and you can estimate somewhere between 6,000 to 7,000 hedge funds exist. But all the recent articles and studies I have read show that close to about $2 trillion over the next five years will be involved in hedge funds. Today, a little less than a quarter of the trades are done by hedge funds.

That will grow to over one-third to bordering up near 40 percent. Two other events, I think, raise the proper concern why you had the two-day conference, why are having this hearing, the first hearing by Congress since Long-Term Capital, which is this is an instrument used by wealthy investors that is now being exposed to a larger audience; what we normally call retailization. That is one trend; not a negative or a positive. It is just a trend.

The second is that we have a lot of new entrants in the area managing funds who have never gone through the Long-Term Capital experience. So you have a retailization, new entrants managing funds, and a market unlike mutual funds or anywhere else like on the street, it is the only area where people do not have to register, do not have to give any information about how they trade, how they perform, any transparency. There is no other instrument like that; no other fund like that.

This is the only one that exists, and you have two events happening simultaneously in the market that raise questions.We have tried many ways, and I compliment you; you have obviously adapted well to Washington since nobody can get you to go on the record or comment on your views or what happened during those two days, and your estimate, so you have done very well at adapting to Washington; no answers to any questions yet. But if I can at least get you to comment on after the hearing, Commissioners Glassman and Campos commented that retailization is not a concern in the hedge fund industry.

At least what I have heard you; you have not said you are not not concerned; that is a double-negative; but do you at least have some comments about the other commissioners' comments that they are not concerned about retailization. Do you see any kind of flashing yellow light that exists to the retailization of hedge funds, an instrument prior to this point being solely that for high networth individuals?

There are about four questions in there. Go ahead and pick any one of them.

Mr. DONALDSON. In the spirit of the openness of our two-day conference, I think that both of those commissioners were reacting to, perhaps making a statement to see if it would be challenged by the audience. In other words, I think they were in a learning process, as we all were. I think that I would revert back to what I said earlier, which is that there is a market demand for retailization, and that brings into question whether the relative sophistication of the "retail" customer or client, and I would submit that there are lots of people who do not have the assets that are currently required for an exclusion, that are very savvy investors, and perhaps should have a right to participate in these vehicles. If that is true, then we have got to somehow take a look at how we can make whatever

the risks are inherent in these funds readily available to a less sophisticated retail investor. That is the problem. That is the opportunity here, and there are strong arguments. Again, I am giving my own personal opinion in terms of the trend here.

There are also hedge funds being set up all the time. Some are large and sophisticated and run by experienced people; some are small, new groups breaking off from, maybe they were in the research department somewhere on Wall Street or they were somewhere else and they said, let us go start a hedge fund, and they are getting into the business. I am concerned about that. I am concerned about the proliferation of hedge funds, and I think we have to take a look.

Mr. EMANUEL. Do I have time for one more or not?

Chairman BAKER. One short one, please, sir.

Mr. EMANUEL. Okay. The last question is, the requirements under the accredited investor, do you think those requirements are still at the right place? Would you make any changes to them?

Mr. DONALDSON. I am not prepared to comment on that yet. I really, again, and I would love to. I do not want to read in the record and bore anybody here with the various exclusions and exemptions and so forth. I would say that we have to take a hard look at the current exemptions and so forth.

Mr. EMANUEL. Thank you.

Chairman BAKER. Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman, and welcome Mr. Chairman also. Some have suggested requiring that the hedge fund advisers be required to register under the Investment Advisers Act. If the advisers of Long-Term Capital Management had so registered, do you think that that would have prevented the bankruptcy of that hedge fund?

Mr. DONALDSON. I think that Long-Term Capital, again, was a very special sort of hedge fund which had a very special area of operation, which used large, huge amounts of leverage. I think that the approach by the President's working group which brought together not only the SEC, but the Treasury and the Federal Reserve, got at the multi-dimensional aspect of Long-Term Capital. I think that the oversight now into the counter-parties and the lenders and so forth, which extends beyond the SEC's purview in certain cases, has been pretty well closed. It is in a lot better shape today than it ever was before. So I am not; I think that is in pretty good shape; that kind of spectacular——

Mrs. BIGGERT. I guess to me, or looking whether there would be mandatory registration of any of the hedge funds, and if there was that registration somehow would it be presumed by investors that these hedge funds are less risky because of having SEC registered status as their adviser?

Mr. DONALDSON. Again, the use of the word "registration"—there are all sorts of different levels of registration, as you know. The simplest level is the registration of the manager, if you will, as opposed to the fund itself. Clearly, registrations of the funds under the 1933 and 1934 Acts is a vast and very costly thing. The simple registration of the manager, if you will, which is a relatively inexpensive thing to do, and it opens the door for the regulators to get in and look and see what is happening.

Mrs. BIGGERT. I think that some of our witnesses later on are going to suggest or believe that retail investors then should not be denied the ability to invest in these funds. Somehow we seem to be talking about that hedge funds are risky, and yet if we have an open policy, their proprietary interests are looked at and will actually make the hedge funds go down, as far as the amount of money that can be returned, because other people will get into what they are doing. So do you think that the funds that if the retailers got into, and I think you suggested earlier that these funds would help to reduce the risk in an investor's portfolio, and yet we think of them as the high risk funds.

Mr. DONALDSON. Again, if you listen to the successful hedge fund managers and if you listen to many academics and so forth, that they would challenge the risk aspect. They would say, with some conviction, that these funds because they have broader powers than long-only mutual funds, that they can reduce the risk; that they can make money in any kind of a market, is what they would say, and that in fact the risk is not as great as somebody that has invested in a fund that has to just invest in common stocks. So I think there are other kinds of risk. There is risk of leverage and there is the risk of records and books and an honest operation. Those are all part of the risk package, and I think we need to be able to take a harder look than we can right now at those risks. I think what comes out of that remains to be seen in terms of how far it is advisable to go to allow "retail" investors to invest in these funds.

The bottom line is that we have got to somehow make investment opportunities available to everybody in this country that wants to invest. We cannot put a fence around a particular investment vehicle, but at the same time we have got to be sure that the investors understand the risks inherent in doing that.

Mrs. BIGGERT. Thank you very much.Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman. Chairman Donaldson, first of all I actually like most of what I have heard today, though as to be expected I have to pass through a fair amount of it. That is okay; that is expected. I apologize for asking what might be a simple question, but when do you expect to have the report finalized? Is there any time frame at all?

Mr. DONALDSON. As I said, we are going out; 45 days from today we will put a cut-off on comments coming from either those who were at our conference, who have read about it or saw it on the Web and so forth. We also hope to complete our further investigation outside of the conference, and I would hope that sooner rather than later we will have a report to you. If I were to put a; if you do not hold me to it exactly, but to give you a parameter, I would hope that sometime in the early fall, by the end of the summer and early fall that we will be back to you. That is our thinking.

Mr. CAPUANO. Thank you. Just a couple of comments before I get a question. I would disagree that you have the ability at the moment to regulate hedge funds if you chose too. Everyone looks to the SEC. I know you have some general powers to basically regulate the trading system, to oversee the trading system, and I would

throw hedge funds into that. That is my interpretation, not necessarily yours.

In response, I would have liked to have heard a stronger response as to why you think it needs to be regulated. Anyone who trades at 25 percent of the trades going on deserves to be overseen by somebody. The degree of that oversight might be subject to debate, and that is fair, but somebody should be looking at what they are doing. I guess for me, I am reasonably satisfied with the direction things are going. I am not satisfied with the speed, but that is the normal situation in a large government.

I guess for me, one of my concerns is, I am hoping that whatever you are thinking about doing, you are also doing in coordination with other regulatory agencies, and particularly those of financial institutions. And I would hope that; is that an accurate commentary or am I off on that?

Mr. DONALDSON. I keep getting back to the various exclusions and exemptions and so forth in terms of our powers, if you will, to regulate, or to even stop short of that; our powers to get inside and know what is going on. That is, I think, a minimal level that this amount of money, $600 billion and growing rapidly, requires. I do not want to pre-judge what we are going to find here. I do not want to pre-judge what the balanced judgment will be coming out of all the work that we have done.

But I think it is just a simple statement that if somebody, if we use this figure; 6,000 to 7,000 hedge funds; $600 billion; and somebody who has spent days and days and hours analyzing it, and a report in the paper today that there are really only 3,000 funds out there, or whatever; it simply illustrates that we do not know.

Mr. CAPUANO. Fair enough, Mr. Chairman. But my concern has never been for the wealthy investor who is very knowledgeable about what he is doing. My concern has always been the impact of these hedge funds on other investors. The last time, through Long-Term Capital, my concern was not for the individuals who may or may not have lost money. My concern honestly in that situation was who allowed the bankers and the other financial institutions to make investments without ever telling anyone that they had done it. Not an SEC problem so much, but a problem with other regulatory agencies, because they were jeopardizing my money investing in a bank, as opposed to if I go into a hedge fund, I know what I am into, so be it. My interest in regulation is really not so much regulation in the classic sense, as much as transparency. Again, not so much for if it is going to be limited, but as hedge funds open their doors; which they are doing; you know it; you have said it; we all understand that as they open their doors, they bring in less sophisticated investors and they also broaden their ability to move that market.

It is the transparency. If you know what you are getting into, if you know your money is at risk, well, fine. You are entitled to make that risk. For me, it is the transparency that is the most important thing. In this particular situation, one question I have for you is right now, even with the limits that are there, a million dollars net worth in today's society in places like New York and San Francisco and Boston and Philadelphia is your house, that you might have bought 20 years ago.

And who is sitting there right now telling me or telling you that they are adhering to those limits? My house might have been worth $1 million last week, but with the current economy maybe it is only worth $700,000. Can you sit here today, or can anyone tell me today, that even with those lowered limits, that we are not actually getting investors in? I have seen advertisements for hedge funds in various financial papers. If that is the case, who is telling me; who is making sure that those less sophisticated investors are not being welcomed in? Who is sitting there guarding the gates?

Chairman BAKER. That will have to be the gentleman's final question.

Mr. DONALDSON. I want to draw a distinction between the desire to have more information about what is going on in the hedge fund, as opposed to our existing laws which allow us to get after fraud and manipulation no matter where it comes from. So we do not need any further powers to do that.

In terms of the issue of financial viability as a criteria; net worth and earning power and so forth; as I tried to explain, I think that that may not be the only criteria that should be out there. Again, you get to the issue of suitability and you get to the issue of transparency and suitability, and there are laws on the books about that, too, in terms of what you are talking about. I am not prepared sitting here today to give you a prescription. That is what we are trying to get at; exactly the question you are talking about and a lot of the other questions. We are trying to understand it ourselves, and we are trying to make some measured judgments based on data and based on the testimony and the investigation that we are doing.

Chairman BAKER. Thank you, sir. Ms. Kelly?

Mrs. KELLY. Thank you very much for holding this hearing.

Mr. Donaldson, we come from the same home town. I am just delighted to have you here, proud to have one of my constituents in your position. We all cheered when we heard you were appointed. So I am glad to have you here.

Sir, we know today that significant long positions in securities have to be disclosed, while significant short positions are not subject to the same kind of disclosure. In your testimony, you mentioned that you believe that the current level of disclosure provides some information on both long and short security positions.

I am wondering if you think that there should not be some kind of a significant short position disclosure whether by a hedge fund or any other investor, trying to figure out what is going on, that parallels the treatment of disclosure with respect to long positions.

Mr. DONALDSON. There is, as you know, on the long side of the market, there is a 5 percent level of disclosure. If you go over 5 percent, you have to disclose it on the long side. In fact, the evidence that we have is that the short positions of hedge funds and others do not come anywhere near that 5 percent level in terms of 5 percent of the total capitalization. That is number one.Number two is that the self-regulatory organizations; the NASD and the New York Stock Exchange; in particular have requirements where short positions are published on a monthly basis. I believe it is monthly.

So they do know in a gross way the long-short position in a wide range of stocks. If you are suggesting that there needs to be a pub-

lic disclosure fund-by-fund of exactly how much money they have in a short position, and the name of the stock and so forth, and publish that, I think we have to take a look at that.

Mrs. KELLY. I am glad to hear you say that, sir, because I analogized this for the investors as being somebody who went on vacation and accidentally dropped their essential glasses in a lake. And they are looking down in that lake and it is slightly murky. They can see the glasses on the bottom of the lake, and they really want to get those glasses. They want to get into the lake, but they are not sure if there is an alligator in the lake. That is what I view some information as being. I think if we are going to build investor information and investor confidence in this market, we have got to make sure that you tell them through transparency and other ways that there is no alligator in the lake and they can get in and do what they want to do.

That being said, I have got one more question, and that is, last August, the NASD issued an investor alert that was entitled Funds of Hedge Funds: High Costs and Risks for Higher Potential Returns. As pooled investments, these funds of funds are described as pooled investments in several unregistered hedge funds. The funds of hedge funds can have a minimum of $25,000 and have an unlimited number of investors. I am wondering if you feel that these funds of hedge funds could represent a danger to less sophisticated investors and what you think we should do about that.

Mr. DONALDSON. The fund of funds that are invested in hedge funds; the vehicles, the parent company are registered vehicles and have to conform to our existing laws. The issue as far as I am concerned is the underlying investments; the hedge funds that they are investing in. Here, as I said before, we do not have enough information and I am not sure that some of the funds of funds have enough information about what is going on inside these units. And this becomes particularly pertinent in terms of evaluation of these investments in the hedge funds. In other words, if somebody is putting their own price on what their performance is without some oversight there, there is room for abuse. So I think as a first step, we just have to know more about what is going on.

Mrs. KELLY. Thank you. Mr. Chairman, I just want to offer one more comment. I want to thank the SEC for the Web site. I think it is laudable that you have already set up the GRDI Web site; the Guaranteed Returns Diversified Incorporated. That is a wonderful way to do outreach to educate investors. I am very hopeful that more; you say in your testimony that you have had 80,000 hits on it. That is terrific. Investor information, investor education is again one of the ways that I believe we can help people understand what they are getting into, and then they will get in and they will be in the market. Thank you, sir, for appearing. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Just be advised, if you are on vacation in Louisiana and drop your glasses in the lake, there is an alligator in every one of them.

[LAUGHTER]

I almost overlooked my distinguished vice Chairman, who has returned from other duties to join us today. Welcome, sir. I know. I was trying to overlook you, but I forgot.

[LAUGHTER]

Mr. OSE. Thank you, Mr. Chairman. Chairman Donaldson, I have asked this question at every meeting regardless of subject, and I am going to ask it again today. What is the status of the application of Nasdaq for exchange status?

Mr. DONALDSON. The issue of Nasdaq becoming an exchange, registered as an exchange, has very broad implications to it. There are bits and pieces of market structure now that need care in terms of how we resolve them. I think that the application of Nasdaq has to be viewed in the context of the overall market structure. That is exactly what we are doing. We are talking to the Nasdaq people in terms of trying to resolve some of the obvious objections we might have to the way they are set up now. More importantly, I think we see this as part of an overall market structure issue, and we have that under review right now.

Mr. OSE. Has the application been deemed complete?

Mr. DONALDSON. I think too often we have taken market structure issues and solved them piece by piece without knowing exactly where we are going. I think that the time has come to take an overview of the entire situation and see what the central marketplace should look like. I think we are trying to do that. I want to assure you that we are not just sitting on that application. We are working very hard to have an overall view of how this total market is evolving.

Mr. OSE. So their submittal is complete or it is not complete? In other words, the requests that SEC has made of them and they responded and given you everything that you have asked for in terms of submittals?

Mr. DONALDSON. I think that, as I say, the issue of Nasdaq's registration, the thing that is before us, the whole issue of public ownership of markets, of where regulation fits; these are big issues and I think we have to look at them as part of a whole, and not piecemeal address things that come into us unless we understand what impact that has on the whole.

Mr. OSE. So how much time is it going to be before we come to a conclusion on this matter?

Mr. DONALDSON. I do not want to put a timetable on it. I will say that some of the market issues and market structure issues have been around for quite a while. I think that we are seeing enough pressure now in terms of new markets, of electronic markets, ECNs, internalization; a whole series of things going on in the marketplace to know that there has to be an overall structure here, and that we cannot just address this thing in an ad hoc way.

Mr. OSE. So there is no time frame in which you are planning to get to an answer?

Mr. DONALDSON. It is a very high priority for us. Let me put it that way.

Mr. OSE. We have been at this; I believe they actually initially filed two years ago.

Mr. DONALDSON. Yes, I have only been at it for three months.

Mr. OSE. I understand that. And you have not fixed it, and I am just appalled.

[LAUGHTER]

But I do appreciate you looking at it. It is a subject that I find timely, given our needs to have markets of some form or another operative in the event of an incident.

Mr. DONALDSON. Right.

Mr. OSE. So next time I see you, I am going to ask you the same question. I am sorry to bring it up in the context of hedge funds, but I asked your assistant when we did the last hearing; mutual funds, thank you; so I am interested in seeing you come to a conclusion on that particular application.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ose.

I am making sure no one else is waiting. I do appreciate your appearance here today. It has been helpful to the committee. I would express a deep interest by all members of the committee in the advantage of the study and report which the agency is generating on this matter. We would certainly want to return for a public discussion of those findings, specifically if there are recommendations that would require any action on our part.

In the meantime, we perhaps will proffer our own questions for inclusion in the public comment period on issues raised today by many members concerning the transparency and adequacy of the current regulatory structure. We look forward to working with you on this and many other matters of interest in the coming months.

Mr. DONALDSON. Terrific.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. DONALDSON. Thank you.

Chairman BAKER. I would also invite our second panel forward at this time. I would like to welcome the members of our second panel. I would like to request each member if possible to constrain your remarks to five minutes. We will make the full written testimony part of our official record for further evaluation by the committee. We welcome each of you here. First, Mr. John Mauldin, President of Millennium Wave Investments. Welcome, Mr. Mauldin.

STATEMENT OF JOHN MAUDLIN, PRESIDENT, MILLENIUM WAVE INVESTMENTS

Mr. MAULDIN. Thank you, Chairman Baker. I thank you for allowing me to share some thoughts on the important matter of who should be allowed to invest in hedge funds. My name is John Mauldin. I am President of Millennium Wave Investments. I have been involved in the alternative investment world since 1989. I speak at investment conferences on a wide variety of topics on hedge funds, and I write a weekly letter that goes to two million readers each week.

Let me summarize quickly my written testimony. It is my contention that the positive values that hedge funds offer to rich investors should also be offered to the middle class, within appropriate and proper regulatory structure. The current two-class structure limits the investment choices of average Americans and makes the pursuit of affordable retirement more difficult than it should be. The rich have a considerable example in growing assets for retirement in that they simply have more assets to begin with. They should not also have an advantage in better investment choices.

Specifically, why should 95 percent of Americans simply because they have less than $1 million be precluded from the same choices as the rich? Why do we assume that those with less than $1 million to be sophisticated enough to understand the risk in stocks, which have lost trillions of investor dollars; stock options, the majority of which expire worthless; futures, where 95 percent of retail investors lose money; mutual funds, 80 percent of which under-perform the market; and a whole host of very high-risk investments, yet are deemed to be incapable of understanding the risk of hedge funds.

Indeed, if hedge funds had performed as mutual funds have done in the last three years, hedge funds would be out of business. The current state of the hedge fund industry is the result of laws that were written in the 1930s and 1940s, long before anyone ever thought of a hedge fund. The path that we have come down is not one of deliberate forethought, but a response on the part of entrepreneurial investment managers to improve investment returns for clients within the current regulatory framework. It is as if we were still driving the cars of today on dirt roads built for the 1930s.

The first hedge fund was formed by Alfred Jones in 1952. It was a simple long-short fund, but it was revolutionary. Due to limitations imposed by Federal securities laws, the only available legal vehicle for him at that time was a private limited partnership. Thus, he was forced by the rules of decades past to not advertise or publicly solicit investors, creating the aura of secrecy. This became the pattern from which future hedge funds were cut. As an aside, hedge fund investors were subject to strict suitability requirements, thus women were the persons most often rejected as investors as they were deemed unsuitable. That was in 1969.

The early hedge funds had a fairly limited range of strategies. As time wore on, different pioneers thought of new ways to earn absolute returns instead of the relative returns of the market. By absolute returns, I mean actual profits at the end of the day. Investors in hedge funds do not want to hear the siren song of relative returns; we are a good fund; the market is down 30 percent, and you are only down 25 percent. The reason hedge funds have grown to the extent they have done is a very simple reason. It is returns. If high net-worth investors and institutions could get the same returns as hedge funds by simply investing in stocks, bonds or mutual funds, why would they choose hedge funds which have higher fees, are hard to find and evaluate, and need more scrutiny? The answer is they would not. The demonstrably observable higher risk-adjusted returns make the effort worth it.

Some hedge funds are very volatile and extremely risky, as are some mutual funds and stocks and futures. Some hedge funds are fairly stable and boring. Lumping all hedge fund styles into the same category can be very misleading. Simply because a person is a member of Congress does not mean they think and act alike. But just as voters get to choose the type of congressional representative they want, so too should investors be able to choose the type of funds and risks that they or their advisers feel appropriate.

What I would suggest is that we need a new hedge fund investment company. Let me just briefly describe what that would do. A hedge fund should be allowed to register with the SEC or the

CFTC as a hedge fund investment company. They would be required to have an annual independent audit, at least quarterly independent evaluations of their assets, and independent administrators, plus they would be subject to SEC or CFTC advertising rules. There would be few, if any limits on the strategies the fund could employ and they could charge a management fee and an incentive fee. They would have to fully disclose not only the relevant risk, but full disclosure of information on their strategies, personnel and management experience. As with mutual funds, there would be no limits on the number of investors. They would be allowed to advertise within current regulatory guidelines, and with certain restrictions, they should be able to take on non-accredited or average investors. Would hedge funds register under such a situation? My belief is that they will.Looking at the situation, we should ask ourselves three questions about opening up the hedge funds to average investors. Number one, is it appropriate? The premise of modern portfolio theory is that you should diversify your portfolio into non-correlated investment asset classes. Many hedge fund styles by any reasonable assessment are highly uncorrelated with the stock and bond markets. High net-worth individuals and institutions are taking advantage of this fact by diversifying a part of their portfolio into hedge funds. This reasonable diversification should be made available to smaller investors as well. No one would suggest that all or even a significant portion of an investor's portfolio should be in hedge funds, but a reasonable diversification is appropriate. There is no real reason to believe that smaller investors cannot understand hedge fund strategies. If investors can be assumed to understand the risk involved with individual U.S. stocks, foreign stocks, commodity futures, currencies, options, mutual funds and real estate, not to mention a host of Reg D offerings, then how could anyone suggest that hedge fund strategies are beyond the ken of investors? A hedge fund is a business generally with a straightforward premise.

It is no more and often far less difficult to understand the risk of a hedge fund than that of a public offering of a bio-tech or a technology company.

The second thing we need to ask, is it the right thing to do? Most hedge funds have an offshore version with lower minimums. The reality is that investors from Botswana have more and better investment choices than do U.S. citizens from Baton Rouge, Louisiana. The only people who benefit from limiting investor choices are those who have a vested interest in not facing the competition from hedge funds. As they seek to protect their turf, they have lost sight of the interests of those whom they should be serving. Those who oppose allowing average investors to have the same choices as the rich must tell us why smaller net-worth investors are less intelligent or are less deserving of options. They should show why average investors should only be allowed funds which are one-way bets on an uncertain future.

I believe that investors would tell you that not allowing them the same choices as the rich is a kind of government protection that they do not need.

Finally, we need to ask, is it fair and just? It would behoove us to remember that the small investor is not even allowed a hedge

fund crumb from the rich man's table. The focus of future regulation should be to make sure there is an honest game on an even playing field, not to exclude certain classes of citizens. To put it simply, it is a matter of choice, it is a matter of equal access, it is a matter of equal opportunity.

I believe it is time to change a system where 95 percent of Americans are relegated to second-class status based solely on their income and wealth, and not on their abilities. It is wrong to deny a person equal opportunity and access to what they feel are the best managers in the world based upon old rules designed for a different time and a different purpose. I hope that someday this committee will see to it that the small investor is invited to sit at the table as equals with the rich. Thank you, Mr. Chairman. I am open for questions.

[The prepared statement of John Mauldin can be found on page 134 in the appendix.]

Chairman BAKER. Thank you, sir. Our next to be heard is Mr. Paul Kamenar, Senior Executive Counsel, the Washington Legal Foundation. Welcome, sir.

STATEMENT OF PAUL KAMENAR, SENIOR EXECUTIVE COUNSEL, WASHINGTON LEGAL FOUNDATION

Mr. KAMENAR. Thank you, Mr. Chairman. Mr. Chairman and members of the committee, my name is Paul Kamenar, Senior Executive Counsel of the Washington Legal Foundation. On behalf of our foundation, I would like to thank the chair and the committee for inviting us to testify on this important aspect of hedge fund regulation, namely the relationship between trial attorneys and short sellers. We applaud the committee and its staff for its interest in this important aspect of the hedge fund issue, and urge the committee to exercise its oversight function and ensure that the SEC addresses this issue as well.

Briefly, WLF is a nonprofit public interest law and policy center based here in Washington, D.C. We advocate free enterprise principles, responsible government, property rights, strong national security defense, and civil justice reform. Earlier this year, WLF launched its investor protection program to protect the stock markets from manipulation; to protect employees, consumers, pensioners and investors from stock losses caused by abusive litigation practices; to encourage congressional regulatory oversight of the conduct of the plaintiff's bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures.

We also regularly oppose excessive attorneys' fees in class action cases on behalf of consumers, and we also filed comments with the SEC last week on their hedge fund roundtable.

As part of our investor protection program, we filed a complaint with the SEC earlier this year; gave copies to the committee here and on the Senate side, as well as at the Department of Justice, calling on the commission to conduct a formal investigation into the short-selling of J.C. Penney stock that occurred shortly before and after a major class action lawsuit was filed against Eckerd Drug Stores, which is owned by J.C. Penney. We think the J.C. Penney case is just the tip of the iceberg, and is a good illustration of the

problem, and therefore I would like to focus on it in my remaining time.

Details of the questionable contacts between the lawyers and the short-sellers is recounted in a January 7 issue of the Wall Street Journal, a copy of which is appended to our written statement. The headline of that article says it all, “Suit Batters Penney Shares, but Serves Short Sellers Well.” In a nutshell, evidence suggests that trial attorneys may be tipping off short-sellers or hedge fund operators as to what major class action lawsuits against publicly traded companies will be filed with the court.

Armed with this material non-public information short positions are able to be taken in the stock of the targeted company. When the suit is filed, the price of the stock in the company falls, and short-sellers stand to gain by the price drop. The U.S. Chamber of Commerce has called upon the SEC to order an informal investigation into our complaint.

According to the Journal article, there are plenty of questions that remain unanswered that the SEC needs to ask, and here are just a few. In the first place, it is questionable who the plaintiff was in this case. It was filed on behalf of a 77-year-old widow named Shirley Minsky of Fort Lauderdale, Florida, who alleged that Eckerd Drugs overcharged consumers for certain liquid medications. There is only one problem. Mrs. Minsky did not authorize the filing of the suit. She learned it from her next door neighbor who read the news the day after the suit was filed. The attorneys claim she authorized the suit. She angrily denied it, saying “they made up the whole damn story.”

The lawyers scrambled to find another lead plaintiff who was substituted for Mrs. Minsky. More troubling than the selection of the plaintiff is the sequence of events and the communications that led up to the filing of the suit. According to the Journal article, Don Reilly, an Eckerd pharmacist, had complained to Federal and State authorities that he believed Eckerd was overcharging its drugs. He was repeatedly contacted by Clifford Murray, a doctor turned analyst with the Boca Raton office of KSH Investment Group. According to Mr. Reilly, Dr. Murray contacted him some 30 to 40 times to update Mr. Reilly on the timing of the class action suit against Eckerd. According to Mr. Reilly, Dr. Murray was communicating with the lead plaintiff’s attorney in the suit before it was filed. In the article, Dr. Murray’s office denies that he had advance knowledge of the suit and claims he did not talk to the lead attorney until after the suit was filed. The SEC needs to find out the truth of this assertion.

Interestingly, the lawsuit was date-stamped 3:59 p.m. on Friday, February 1, 2002, which is just one minute before the close of the market for the week. Jeff Sultan, head of the local KSH, claimed that neither he nor his firm sold Penney stock short, but when asked why in this case Dr. Murray spent so much time talking to the pharmacist and whether the broker-dealer had been advising clients to short the stock, Mr. Sultan did not respond. The SEC needs to get Mr. Sultan to respond to those questions.

By the time the suit was filed and amended in April, 2002, J.C. Penney stock dropped a total of 32 percent since mid-November, 2001. Short-selling activity in the stock rose 43 percent between

January 15 and February 15. A subsequent investigation by the Florida Attorney General's office concluded that Eckerd did not overcharge for its drugs. We do note that the aggregate figures of the short-selling was only in a monthly report, and we think that weekly and daily reports may be better, as suggested by Representative Kelly. Indeed, the Committee on Government Operations recommended such a thing in 1991.

Finally, we think that if the SEC says there is no violation that has occurred here, whether it is a 10b-5 under the misappropriation theory under O'Hagan, that may be fine, but it is important for the public and this committee to know that, because the next question would be whether new SEC regulations should be promulgated to curb this practice, or whether remedial legislation is warranted.

Thank you very much, Mr. Chairman, for the opportunity to give this testimony, and I am open to any questions.

[The prepared statement of Paul Kamenar can be found on page 88 in the appendix.]

Chairman BAKER. Thank you, Mr. Kamenar. Our next witness is Mr. Terry F. Lenzner, Chairman, Investigative Group International. Welcome, sir.

STATEMENT OF TERRY LENZER, CHAIRMAN, INVESTIGATIVE GROUP INTERNATIONAL

Mr. LENZNER. Thank you, Mr. Chairman. I appreciate the Chairman and this committee and this committee staff looking at a number of activities and issues that I believe have been flying below the regulatory radar screen to the detriment of a number of American companies.

These activities are abusive tactics by short-sellers, exacerbated by the lack of information on the short selling positions, which was brought up by a congresswoman earlier today, and a behind the scenes an unholy alliance we now know between the short sellers and the plaintiffs bar. The result of these activities that have not been on the radar screen is the loss of jobs, loss of value to shareholders, loss of access to the capital markets by American corporations, and overall loss to the gross national products estimated at about 2 percent for the last year. I want to quickly add that I am not against the hedge funds per se. I am simply against those funds that conduct abusive activities.

In the past, about 15 years ago, Mr. Chairman, when I started looking at short sellers, they were using a very laborious process to put out false inflammatory information about particular companies. A few real examples; a short seller calls up the FBI, and I know the Chairman of the committee is a former FBI agent, and tells the FBI that company X is an organized crime front and is involved in money laundering. They then call the press to tell them that the FBI is investigating the company. The press then calls the FBI and the FBI can neither confirm nor deny that allegation, and the press runs with the story and damages instantaneously the reputation of that company.

I have seen examples in the past where they acted as Wall Street Journal reporters to get false information to vendors, clients, customers, and regulatory authorities that the company was about to

be indicted; that the company was about to go bankrupt; the company was about to lose its permit or a major contract; again, with the intent of depressing the stock price.

With the growth of the Internet, and the Chairman noted this earlier, and the use of pseudonyms on the Internet, there has been a virtual explosion of inexpensive instantaneous communications that have been used to damage companies' reputations and depress the stock price. One of the most dramatic examples is the CareMark Corporation where a short seller went on the Internet, posed as the Chairman of the company, predicted that the fourth quarter results were going to be 50 percent less than what the company and the street had anticipated, and the company lost $400 million in net worth in less than two weeks. And the Allied Capital case; an individual by the name of David Einhorn from Greenlight Capital gave a talk at a charity event and named Allied Capital as a company with dubious accounting.

The day after that, the company was hit with a deluge of lawsuits by the plaintiffs bar and the co-head of the class action became Milberg Weiss; you will hear about them later. The allegation was that the valuation of assets was over-inflated and that Arthur Andersen had at one-time been their auditor. The company fought back. They mounted a vigorous campaign.

They fought back against the lawsuits, and very recently a judge ruled in their favor and dismissed the case on the grounds that there was simply no basis on which to infer that Allied's evaluation of its investments were in fact incorrect or inflated, and thus no basis to infer that Allied's accounting policies resulted in fraudulent over-valuation. Since Allied's actual valuation policies were public, as was all adverse information about the companies in which Allied had invested, plaintiffs have not alleged that Allied concealed any facts from its investors. I might say that the gentleman to my left, Mr. Lamont, in a public statement that I have recently seen, criticized the company for fighting back.

My conclusion is had the company not fought back while its stock suffered, it would have been battered far worse if it had not responded, as is its right, to that attack.

We also had another individual who comments frequently on short sellers, Herb Greenberg, Onthestreet.com, echoed Mr. Einhorn's remarks, and I do not know if Mr. Rocker shorted the stock, but Mr. Rocker owns 10 percent of Onthestreet.com, and I think at some point the SEC ought to look at whether there is any kind of communication between analysts and the short sellers.

What is missing is the information. Companies and the public and regulatory authorities get aggregate amounts of short positions every 30 days. Recently, I was watching the Moore Corporation and on February 15 it had 900,000 shares short, and on March 15 it had 14 million shares short. No information in between, and as a result if I was Chairman or CEO of that company, I would have been alarmed when I picked up a newspaper on the 15th of March and saw that my short position had grown so immensely.

The other questions, I was glad to see the Chairman announce today that 13d, the 5 percent reporting requirement, does apply to short sellers, because I have asked a number of senior SEC officials and security lawyers if 13d applied and nobody seems to know. In

fact, nobody seems to know why there is so little information published about the short positions. The Chairman did say 13d applied, but he said they had looked and had not seen any holdings in excess of 5 percent. The question I would suggest is, as in the long positions, has the SEC looked to see if there are concert parties, that is to say a number of short sellers who are shorting the stock at the same time in concert with each other, that exceeds 5 percent. If it does, then they do have to file under 13d. We have seen enough patterns of communications and coordination between short sellers in cases like Allied Capital to think that that does exist and the SEC ought to take a look at it.

Now, the relationship between the plaintiffs bar and the hedge funds; you do not have to go any farther than the Hedge Fund Association. If you click on their Web site, and most of the short sellers are represented by the Hedge Fund Association, one of their members of the board of directors is Randall Steinmeyer of the Milberg Weiss firm. If you click on his name, you get instant access to the Milberg Weiss Web site. So that if you are a short seller or a plaintiff looking for a law firm, it would be very easy to find them.Now, I just want to talk briefly about the Dynegy case, because it kind of wraps up all the issues that I have been talking about, including Mr. Steinmeyer. An individual by the name of Ted Beatty became unhappy and concerned about Dynegy's accounting practices. He thought they were wash transactions and they had a banking relationship that they called Project Alpha. He gave this information to a short seller who immediately shorted the stock. He also gave that information to the Wall Street Journal, who published an article on April 3, 2002. Unfortunately for the short sellers who had taken positions in anticipation of this article, the price went up and not down, and they panicked, and they called Mr. Beatty and said, can you give us more information to make the stock go down? He said, at this point I had been threatened with a lawsuit from the company that he had now left, and I want a lawyer. They said just give us the documents, and we will get you a lawyer, and we want you to be the front man and we want you to talk to the newspapers about Dynegy, talk to the regulators about it, and talk to the credit rating agencies about it. Indeed, he did do all of that and Moody's lowered their rating based on what he told them.

The next thing he heard was that Mr. Steinmeyer had been approached by the short sellers to represent Mr. Beatty. Mr. Steinmeyer called Mr. Beatty on April 15, upset, frustrated and unhappy that the Wall Street Journal had not depressed the stock, but rather the stock had gone up, and insisted as part of his legal representation that Beatty send him materials that he took from Dynegy immediately. Ultimately, Beatty did and Steinmeyer turned around and used them to file a lawsuit against Dynegy. Steinmeyer never represented Beatty, never gave him a single piece of advice, and never talked to him about any of the issues that were of concern to him.

And the stock did then decline. But when Steinmeyer, the lawyer, went to Beatty and told him, I am upset that the stock price had not fallen during that period of time, it inferred to me that Steinmeyer was working closely with the short sellers. Indeed,

when Beatty told the Wall Street Journal that, that Steinmeyer had told him not only was he working closely with the short sellers, but the short sellers had made $150 million on shorting Dynegy stock between April and May, Steinmeyer called from Europe to the Beattys and said if that is printed, we no longer represent you. He was extremely upset and told them that if was off the record, when he told them about his relationship with the short sellers.

Chairman BAKER. Can you begin to wrap up for me, sir?

Mr. LENZNER. So in conclusion, what I am suggesting is this is a clear plan of the relationship between these two groups, whose major interest is to drive prices down. I believe if the commission and this committee looks further into this, you will see a very profound historical pattern of the same kind of activity.Thank you.

[The prepared statement of Terry F. Lenzer can be found on page 121 in the appendix.]

Chairman BAKER. Thank you, sir, for your comments. Our next witness is Mr. Owen Lamont, Associate Professor of Finance, Graduate School of Business, University of Chicago. Welcome, Mr. Lamont.

STATEMENT OF OWEN LAMONT, ASSOCIATE PROFESSOR OF FINANCE, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO

Mr. LAMONT. Thank you, Mr. Chairman. I am pleased to have this opportunity to testify about the state of the hedge fund industry and the role of short sellers in capital markets, and I thank you, Mr. Chairman and the members of the committee, for this opportunity.As an economist, I am concerned with prices. We need to get the prices right. To get the prices right, we need to get all information, negative and positive, into the market. When security prices are wrong, resources are wasted and investors are hurt. One way to get negative information into the market is through short sellers. Without short sellers, stock prices can be too high. Stocks can get overpriced, as only optimistic opinions are reflected in the stock price.

Our current financial system is not set up to encourage short selling. We have well-developed institutions such as long-only mutual funds to encourage investors to go long, but we do not have many institutions to encourage them to go short. As events of the past few years have made clear, the infrastructure of our system; the analysts, the underwriters, the issuing firms, the accounting firms, and some elements of the media; have an overly optimistic bias. In addition to this optimistic bias, there are technical issues about short selling. Sometimes it is difficult to short, or impossible to short certain stocks for technical reasons. Simply put, our system is not set up to facilitate short selling.

A variety of evidence suggests that when stocks are difficult to short, they get overpriced. One example I have studied is battles between short sellers and firms. We have heard about some current battles. I have studied battles in history. Firms do not like it when someone shorts their stock, and sometimes they take actions against short sellers. An example is Solv-Ex, a firm that in 1996 claimed to have technology for economically extracting crude oil from tar-laden sand. In 1996, Solv-Ex took some anti-shorting ac-

tions. It attempted to organize a short squeeze, and it later filed suit against short sellers, claiming the short sellers had illegally spread false information. But in this case, it was Solv-Ex that was engaged in illegal activities, not the short sellers. Subsequent to this anti-shorting action, Solv-Ex de-listed, the SEC investigated, and the court ruled in 2000 that the firm had indeed defrauded investors.It turns out, based on the historical record, that Solv-Ex is a typical case. The evidence shows that when you have these fights against short sellers and firms, short sellers are usually vindicated by subsequent events. Firms that take anti-shorting actions tend to have falling prices in the following years, suggesting that they were overpriced to begin with, perhaps due to fraud by management; perhaps just due to excessively optimistic investor expectations.

Short sellers are good at detecting and publicizing fraud on the part of firms. Again, recent events of the past few years have shown that we need more whistleblowers and we need to encourage people to be whistleblowers. The SEC and the regulators cannot be our only line of defense against corporate fraud. To protect investors, we need a vibrant short selling community.

Even absent corporate fraud, though, short sellers play an important role in protecting individual investors from overpriced stocks. When informed traders are not able to go short, it will tend to be the small investors who unwittingly buy the overpriced stocks and the smart money stays away. For example, during the tech stock mania in 2000, there were some stocks that were identifiably overpriced, but they were not shortable for technical reasons. The victims in this case were the individual investors who bought those stocks and later suffered substantial losses.

In my opinion, therefore, we should change the current lopsided system which discourages short selling. First, in the narrow technical arena, we need to find ways to make the equity lending system work better. It seems particularly unhelpful that firms are sometimes able to abuse various aspects of the system in order to prevent short selling. Second, in the broader arena, we need to continue to encourage the development of institutions that channel investor capital into short selling. It would benefit both the efficiency of prices and the welfare of investors if more capital were allocated to strategies involving short selling; for example market-neutral long-short funds. This goal could be accomplished through increased investment in hedge funds, retailization of hedge funds, or it could be accomplished through mutual funds that employ long-short strategies.

What we should avoid is a set of new regulations that limit the freedom of hedge funds to exploit and correct mis-pricing. I fear that such new regulation might have the unintended consequence of making short selling harder than it already is. There is a natural tendency to feel that short selling is somehow inherently malevolent and un-American. To the contrary, nothing is more beneficial to our economy than detecting fraud and correcting overpricing. If we are going to have liquid markets that properly reflect available information, investors must be able to both buy and sell.

Of course, it is appropriate for the SEC and other authorities to investigate possible cases of market manipulation, but the big story of the past few years has been malfeasance on the part of the long

side; the issuing firms, the analysts, the accounting firms, and the underwriters. The short sellers have been the heroes of the past few years, alerting the public and the authorities to corporate fraud.

Congress and the SEC will continue to hear complaints about short selling from firms, and we have heard some today. As I mentioned earlier, the evidence shows that when companies and short sellers fight, it is the short sellers who are usually vindicated by subsequent events. For example, in 1989 before this House, the House Committee on Government Operations, the Commerce, Consumer and Monetary Affairs Subcommittee, held hearings about the alleged evils of short selling featuring testimony from supposedly victimized firms. Officials from three firms testified. Subsequent to this testimony, the Presidents of two out of these three firms were charged with fraud by the SEC. So when you hear companies complain, keep in mind that short sellers are often the good guys.

Thank you for this opportunity to testify, and I would be delighted to answer any questions.

[The prepared statement of Owen Lamont can be found on page 109 in the appendix.]

Chairman BAKER. Thank you, Mr. Lamont. Our last panelist today is Mr. David A. Rocker, General Partner, Rocker Partners. Welcome, sir

STATEMENT OF DAVID A. ROCKER, GENERAL PARTNER, ROCKER PARTNERS, LP

Mr. ROCKER. Thank you, sir. I am honored to have this opportunity to address the House Subcommittee on Capital Markets to offer my views on hedge funds, short selling, and the appropriateness, of additional regulation.

Rocker Partners is an 18-year-old firm with a contrarian style. While we maintain both long and short positions, we have focused our research efforts most heavily in recent years on short selling because we have identified more stocks which we have felt were overvalued than those which we felt were attractive. We are generally viewed as a specialized manager, and our investors, primarily wealthy families and individuals and institutions such as universities, hospitals and endowments, often use us as a risk-reducing hedge against their long-biased investments.

Hedge funds have grown rapidly because they have served both of their constituencies, investors and their managers, better than more conventional alternatives. Over the last six years, which encompassed both the expansion of the biggest equity bubble this country has ever seen, and its subsequent deflation, an investment in the average-performing mutual fund would have remained essentially unchanged, but the same investment in the average-performing hedge fund would have appreciated approximately 75 percent, and would have done so with lesser volatility.

Investors have also been attracted to hedge funds because of the greater identity of interests between the fund manager and the investor. Substantial personal assets of the hedge fund manager and their families are typically co-invested alongside limited partners,

and such investments typically represent a much higher percentage of total assets under management than is the case in mutual funds.

Hedge funds frequently provide a more attractive financial opportunity for successful managers, and a broader investment flexibility available in the hedge fund structure has also proven appealing. As a result, many former mutual fund managers have joined or started hedge funds in recent years. While there is considerable discussion as to whether hedge funds require greater regulation, it is important to recognize that even unregulated funds are already subject to a substantial degree of oversight.

Sophisticated investors, especially in mature funds such as ours, impose tremendous demands on managers with whom they choose to invest, including among other things that the fund has formal compliance policies, appropriate restrictions on employee trading, investment transparency, operational efficiency, risk management techniques and a host of other protective requirements. Those managers that do not or cannot provide these protections to the investor marketplace generally do not succeed or survive. There are lots of choices. Additionally, the co-investment of the hedge fund manager's personal and family assets help serve as a self-governing mechanism.

The highly publicized hedge fund blowups in recent years must be placed in perspective. Such funds have represented fewer than one-quarter of one percent of the industry, and the superior investment results cited earlier include the losses from these entities. As the present structure has served investors well during both rising and falling markets, I believe that additional regulation is neither necessary nor desirable. Existing regulations effectively applied, coupled with the extensive due diligence and operational requirements of investors, have proven sufficient to date. Anyone willing to commit fraud will not be deterred from doing so by a registration statement. With few notable exceptions, hedge funds have proven less risky, so the present focus on them in this context is somewhat puzzling.

I am not going to comment on retailization, as it is not an area of expertise and time is short. I would like now to turn my attention to short selling and the important role I believe it plays in creating more liquid, balanced and fair markets. Short sellers already operate in a field tilted sharply against them, and considerable restrictions and risks relate specifically and often uniquely to this strategy.

Unlike a long investor who can buy a stock at any price or repeatedly at ever-higher prices intra-day, the short seller must initiate his or her position only on an uptick; a price above the preceding trading price. Buyers do not have to wait for downticks.In contrast to a long position, in which only the initial investment can be lost, there is a risk of potentially unlimited loss in short positions. The short seller is obligated to pay dividends to the holder from whom he borrows stock, and most especially there is the potential loss of one's ability to determine when a short position is purchased or covered. If the supply of borrowable stock dries up, the short seller may be involuntarily bought in by his broker in what is generally known as a short squeeze.

The short seller has no control over when the stock is bought in or the price at which it is executed. The situation is clearly distinct from that of the long holder, who cannot be forced into an involuntary sale.

The contribution of the short seller to more efficient markets can be best evaluated in the context of the stock market in the last six years. An equity bubble of extraordinary proportions developed in the late 1990s, peaking in early 2000. The Internet mania was just the most visible part of this general hysteria. Since the peak, the bubble has deflated, costing investors some $7 trillion. By the way, I would encourage you to read an article that I wrote for Barron's "A Crowded Trade," which is part of the package that I included, and it covers some of the structural issues that have made it so.

The goal of regulatory policy must be to establish fair and safe markets for investors. In considering what if any regulatory changes are appropriate, I believe it is important to reflect on the forces that created the bubble, as well as those which have led to its demise. In that connection, it is important to understand the structural bullish bias of the market. Shareholders, of course, want their stocks rising. Corporate officers desire higher prices, as this serves both as their report card and, thanks to the liberal use of options which should be treated as expenses, the key to enormous personal wealth. Higher stock prices also provide inexpensive acquisition currency. Security analysts clearly want stocks higher to validate their recommendations. For every transaction, there must be both a seller and a buyer.

Thus, it is interesting to note that while 50 percent of stock transactions are, by definition, sales, purchase recommendations by analysts are 10 to 20 times more numerous than sale recommendations.The recent Wall Street settlement has focused on the pressure placed on analysts from internal investment banking. The pressures from clients and corporate executives have received much less attention. Analysts who recommend the sale of stock risk the ire of the clients who own it. These clients complain to research directors, and can withhold favorable votes and reviews important to an analyst's compensation.

Similarly, corporate executives frequently react in a hostile manner to anyone who downgrades their stock, restricting his or her contact with the company and thereby making future analysis of the company more difficult.

Collectively, these factors, coupled with a cheerleading media, created the bubble. Anyone challenging the valuation of a company or the integrity of its financial statements was most unwelcome in this environment. Analysts and market strategists who either warned of overvaluation or were insufficiently bullish were pushed aside and replaced by those who went along with the irrational exuberance.

Short sellers, through their research and public skepticism, provide a much-needed counterpoint to the bullish bias. They are willing to ask touch questions of management in meetings and on conference calls, thereby providing a more balanced view for listeners. Investors benefit by getting both sides of the story when the views of short sellers appear in the media. Several articles I have written are enclosed as part of this presentation.

Short sellers have helped uncover many frauds and accounting abuses in recent years, including Tyco, Enron, Conseco, AOL, Boston Chicken, Network Associates and Lernout and Hauspie, among a host of others. Short sellers serve as unpaid, albeit self-interested, detectives who willingly share their findings with the SEC, which has acknowledged the usefulness of these inputs. Although there have been occasional instances in which short sellers have been accused of circulating misleading stories, these instances are dwarfed both in number and magnitude by the misleading stories circulated by long holders and the issuers themselves. Because of the greater risk in short selling, research done by short sellers has tended to be more careful and more accurate than most.

As Gretchen Morgenson of the New York Times recently reported, and I quote, "if you own shares in a company that declares war on short sellers, there is only one thing to do: sell your stake. That is the message of a new study by Owen Lamont, associate professor of finance at the University of Chicago's graduate school of business. That study, which covers 1977 to 2002, shows not only that the stocks of companies who try to thwart short sellers are generally overpriced, but often that the short sellers are dead right."

The value of short selling as a means for creating greater liquidity and orderly markets is well understood. Specialists of the major exchanges are required to sell short to help offset an imbalance of orders. Trading desks at brokerage firms do so as well to facilitate customer orders. It is also important to note that over two-thirds of short selling is simply related to arbitrage activities.

So when you see the short interest figures in the papers, it is important to put them in this context.

Any effort to further restrict short selling should be rejected. While short sellers seem to attract a disproportionate amount of attention, usually from companies with questionable accounting or flawed business models who do not welcome scrutiny, the number of short biased firms are few in number and are actually shrinking. Many short sellers were driven out of business during the bubble, and even today they represent the only sub-category of hedge funds that has seen net redemptions in recent years. Of nearly 6,000 hedge funds, short biased hedge funds with asset bases of $100 million or more number fewer than 10; 10 out of 6,000; and the total assets managed by these entities is well under 1 percent of the total assets managed by all hedge funds. That few managers have chosen this strategy or have been able to survive suggests that there are easier ways to make a living.

The short interest in each stock is reported monthly, yet there are proposals circulating, most visibly from the Full Disclosure Coalition now in formation, by the Washington law firm Patton Boggs, which would seek to have individual short sellers detail their short positions in periodic filings. The claim being made is that this would level the playing field, but as we discussed earlier, the playing field is already tilted sharply against the short seller. Such disclosure requirements would serve only to make targets of individual short sellers and likely drive them out of business. Some publications are designed specifically for the purpose of creating short squeezes which can be exploited by traders and mutual funds

who know that short sellers cannot defend themselves from escalating prices by selling on downticks. Most companies simply ignore short sellers, recognizing that there are differences of opinion in free markets, and go about their business.

Chairman BAKER. Can you wrap up?

Mr. ROCKER. In light of Mr. Lamont's findings, it is interesting to see which companies will be part of this coalition. I am just about finished.

The reason the Williams Act requires the filing of a 13D is to alert a company that someone is accumulating more than 5 percent of their shares and may be attempting a creeping tender. There is no such threat from a short position, as being short does not give anyone any vote or any authority whatsoever.

Given the positive contribution by short sellers and the evident shrinkage in their number, it is hoped that consideration should be given to truly leveling the playing field by modifying the uptick rule to make is less restrictive. This would contribute to greater stability in today's electronically-driven markets. Short selling plays an important role in public capital markets. Any additional bias in favor of long investors will further erode this important counterweight. Short selling is an important investment tool as part of a proper risk reduction investment strategy. The marketplace not only understands the benefit of short selling, in fact it requires it. I thank you for your time and your attention. I would be happy to answer questions.

[The prepared statement of David A. Rocker can be found on page 159 in the appendix.]

Chairman BAKER. Thank you, sir. Mr. Lamont and Mr. Rocker, from your testimony it would appear that you view the short selling world different and distinctly in character from that of the equity side. Is it not sort of a logical thing that you follow the money; that when the analysts were trumpeting the longside to drive prices up, there was a reason for that. Is it your view that the same manipulative forces do not work on the short side of the ledger as well? That reporting of information adverse to a corporate outlook has financial consequences of value to those engaged in that activity.

Let me characterize the question properly. I see extraordinary value in short selling. I think it performs a market function that we should foster and encourage, but the reasons for the disparity in reporting of the historic misconduct is a democratization on the side of equities, with the limitations on the number of people who can successfully participate in the hedge fund activity, and a view by some that if rich people lose money, so what. So the Chairman appeared here today of the SEC and indicated we do not even know how many of these funds there are, much less what they are doing. In the absence of that information, how can we then draw the conclusion that one side is good and the other is bad. Can you respond to that?

Mr. LAMONT. As a theoretical matter, of course, you might expect manipulation to take place on the long side and the short side. Certainly, there is manipulation that takes place on the short side, it is just rare given that so few people ever short and it is so hard to short, and given that the firms really control information; you

know, if you are Enron you control the flow of information going out of Enron. Historically, it has been the long side that has done the manipulation and has done the fraud.

Chairman BAKER. But that has been the result of expectations by the broad consumer group wanting to get in on what was perceived to be the 15 to 20 percent rate of return. You threw money and did not ask the questions. That was because it was open to the smallest of investor and the lowest dollar denomination possible. Whereas on the other side, it is a much more restrictive world in which the losers are folks of considerable assets, generally speaking. So I am just trying to frame it. You may be absolutely right, but it would appear on the statistical data available we have not sufficient sampling on the short side to really know how equitably or efficiently it works as related to the volume of information available on the long side. Is that fair?

Mr. LAMONT. You are thinking about manipulation, right?

Chairman BAKER. Those activities which are not conducive to good public policy.

Mr. LAMONT. The SEC and the other regulatory bodies, the NYSE and the NASD, do have full powers; they have the power to investigate manipulation and they do investigate manipulation on the short side. As Mr. Rocker mentioned, there are all kinds of limitations. There are many extra limitations on short selling that are not true on going long.

Chairman BAKER. On overt misrepresentation of fact or manipulation of corporate performance which is known not to be accurate, certainly. I think the Chairman spoke rather at length this morning, though, to the veil that appears to be between him and his agency and understanding what really is happening in that sector of the market. I am not picking arbitrarily on you two guys, but we do not have enough information, at least in my perspective, to make those absolute clear determinations between the two sectors of the market. I think both are extraordinarily important for our overall economic vitality.

Let me jump to the other side, because we have been here awhile, and I certainly want to get to Mr. Kanjorski as well. Mr. Mauldin, following your logic about the openness of the market to all who choose to come, that would lead me to the next question. What about suitability requirements period? I mean, why don't we let everybody; the young person cutting grass for three bucks an hour; invest his money wherever he sees fit. Is that the logical end conclusion of not having some criteria for investing?

Mr. MAULDIN. The answer is yes. But under the framework that I am proposing, and I have got it in my written statement, what I would suggest is that opening up hedge funds to the average investor does pose some risks. The primary risk that it poses is that investors look at the great returns and jump into the funds not understanding and having no background for that.

I think there ought to be a period of about seven to ten years where average investors could only invest in this new hedge fund investment company if they passed some program showing that they were suitable; showing that they could understand hedge funds; or if they went through a broker or an investment adviser who passed appropriate tests showing that they understood hedge

funds. So you give that seven to ten year period to allow investors to begin to get used to the different types of risk that hedge funds pose.

It is not a matter of risk or no risk. Every market has risk. It is just you get to choose which risk you want. So as investors become aware of it and understand those risks, they say yes, I want that risk as opposed to the risk in stocks or bonds.

Chairman BAKER. So you would suggest we proceed, but proceed with caution.

Mr. MAULDIN. Absolutely. Hedge funds are not investment nirvana. They have got all sorts of risks. I spend a great portion of my day every day investigating hedge funds trying to find out where the risks are. Some of them are very scary. I would not for a minute suggest that they are not. But you choose your risk. That is why investors now have a 401k that is a 201K. They had very limited options.

Chairman BAKER. We have a dilemma in the sense that hedge fund information is generally deemed as proprietary, and if we disclose what we do our competitors will then encroach on our market diminishing our profitability.

Mr. MAULDIN. I am sorry to interrupt, but I think that is kind of a false idea. It is amazing how much information; you can go on my Web site. I have got a due diligence document with well over 100 questions that I ask a hedge fund when I go in. It is amazing what they will tell you.

Chairman BAKER. But it is also amazing what they won't. LTCM said give me a million dollars and go away for a few years and do not call me.

Mr. MAULDIN. If you invested in LTCM, you got what you deserved.

Chairman BAKER. Yes, but you could not get behind the screen to determine what you were buying.

Mr. MAULDIN. But the point is that under a hedge fund investment company that I would open up to the public, you do not allow companies that do not open up in. You require the disclosures. You require the transparency.

Chairman BAKER. Even sophisticated lenders; insured depositories; were throwing money at them because they had three years of back-to-back successful investment activities without a two-day back-to-back trading loss until the demise.

Mr. MAULDIN. Let us look at what happened to Long-Term Capital. You had very smart managers who took highly concentrated positions in markets that they could not easily exit. That is the same thing that happened in the mutual fund Janus 20, where investors lost $10 billion as they had technology stocks that they could not get out of. It is not a matter of risk or no risk. It is a matter of choosing your risk. You still have to have transparency and disclosure; you absolutely have to have that.

Chairman BAKER. I am not disagreeing with you. I am pressing you because it just begs the question perhaps, but it is alright for everyone to defend their home; it is another thing to give a loaded hand-gun to a six-year-old. I think that is where we are trying to balance the equities. When do you understand the risk you are taking, and when is it advisable for us to require more information to

be made available so that an educated person can take the risk that is advisable for them?

Mr. MAULDIN. I think that part of the cure here is to require disclosure and to require more information. I would do that within the context of the hedge fund investment company. You allow the hedge funds to disclose. Here is what we do. Most hedge funds, they are businesses. They have very straightforward premises; we do this; we are seeking this type of return; and this is the way we go about it. It is not more difficult to understand than a Cisco or a General Motors or a GE.

You just simply give the investors, the individuals the opportunity. To simply say that somebody; I mean, I have people who have MBAs in finance. I cannot tell them about hedge funds because they do not have $1 million. Most of the members of this committee, I could not talk to you about the hedge funds that you are overseeing because the laws say that I am not allowed to tell you about these funds because you are not sophisticated enough. These are very strange rules.

Chairman BAKER. But I agree with that rule.

[LAUGHTER]

Mr. Kanjorski?

Mr. KANJORSKI. You can tell us about it. We just cannot engage in it.

Mr. MAULDIN. I cannot. No, sir.

Mr. KANJORSKI. You mean you cannot even tell me what you do?

Mr. MAULDIN. I can tell you what I do, but I cannot talk to you about a specific fund.

Mr. KANJORSKI. No, not to recommend that we get into it because I am not a qualified investor.

Mr. MAULDIN. I am not even supposed to discuss a specific fund or a specific investment with somebody who is not an accredited investor, and not deemed suitable for that investment.

Mr. KANJORSKI. Yes, carrying your logic to a further extent, maybe this committee should pass a law barring Bill Bennett from casinos.

Mr. MAULDIN. It could happen.

Mr. KANJORSKI. The question I have, we are not in the business of guaranteeing people a return or protection on their investment. We should be in the business of making sure there is not fraud and abuse.

Mr. MAULDIN. Absolutely.

Mr. KANJORSKI. And that hopefully opening up markets to qualified individuals, but this whole idea of giving a test; are you serious? I mean, you don't give anybody a test when they walk into a casino, and yet 90 percent of them lose money when they walk into a casino. I have sat at card tables and have been absolutely awed when people will split two tens. Any book you read on it will mathematically tell you that is a stupid bet, but people have a right to make a stupid bet. People have the right to buy stupid things.

Mr. MAULDIN. If this committee decided that we should open up the investment world and wanted to allow anybody in without having some deemed suitability, that would be the committee's decision. There are a number of courses that are offered by independent academic institutions that would prepare somebody to be

able to analyze the risk in hedge funds. I personally think they should do that before they buy stocks, but that is a different story.

Mr. KANJORSKI. Going to the retailization of this whole thing; isn't there enough money in the hedge funds now, $650 billion, a growth of 10 times in 10 years? Isn't that enough money? Why are we worried about encouraging or opening the market to more people or more money?

Mr. MAULDIN. It is not about how much money is in the hedge funds. It is about the fairness of the situation. This is all a matter of equity. Why should a rich person have an advantage that a less-richer person does not? Why do the rich get the best deals?

Mr. KANJORSKI. Rich people who derive their riches from financial transactions are usually smarter people, too, aren't they? I mean, there is some correlation there.

Mr. MAULDIN. I deal with a lot of those people and I am not certain that is true; except for my clients, of course.

[LAUGHTER]

Mr. KANJORSKI. It may not be true, but they are rich enough to pay the tuition to lose.

Mr. MAULDIN. That is correct. Investors are rich enough to pay a tuition to get in their 401K and put it in an index fund that drops 40 percent.

Mr. KANJORSKI. From the experiences I have heard before this committee for the last several years, all of us seem to brag about how many more people are in the equity markets. I am not certain that that is something we should be bragging about. I am not certain that more than 50 percent of the people have the financial sophistication to be in the equity markets. But I am not going to bar them from being there. I think that is the marketplace. They lose, that is their tuition.

Hopefully they are smart enough that they only have to lose one time. But if they want to play, I do not see the role of government in all these things. What is our role that we have to force very sophisticated organizations that have put together a program to invest, and now we have got to force them to tell the whole world what; I think that is what the Chairman was getting at; what their thought process is and what they are going to do and how they are going to it, so that their competitor can read that. Is that our system?

Mr. MAULDIN. That is not what I am suggesting. I am saying that this is a voluntary thing. You would not require every hedge fund to register. You would offer hedge funds that would like to broaden their base the opportunity to register. I do not want to disturb the status quo. I want to create a new hedge fund investment company.

Mr. KANJORSKI. I would suggest then the very sharp hedge funds. They probably do not have a heck of a lot of difficulty attracting capital if they are making a lot of money and they have a long history record of being successful. I imagine people are knocking on their doors hoping to qualify and let them take their money and invest it and get a high return. Why are we so interested in putting this in a retail business to suggest that we want to bring a lot more money into hedge funds, and why do we want to get a lot more less sophisticated people into hedge funds as a

government policy? I do not see that is our role. I would rather build fences from people jumping over cliffs, rather than paving roads to cliffs.

Mr. MAULDIN. I still think is comes back to an issue of fairness. Hedge funds have clearly out-performed mutual fund stocks. There is no question about that. Why should a smaller investor simply because he does not have $1 million, and the real practical limit is $4 million to $5 million; it is not $1 million; why should smaller investors be prevented from sitting at the same table as a rich person? Why shouldn't they have access to the best managers in the world?

Mr. KANJORSKI. Well, I just came back from my office and I read a scam where eight of my constituents were scammed out of about $1.2 million. When you read the scam, and you read the level of sophistication of these people, you have no wonder why they were scammed. To encourage them into what I would think is the Ph.D area of investment, with the idea that instead of getting a sounder return on a safer investment, they are going to go out seeking the higher return with the idea that these people; hedge funds do lose money, don't they?

Mr. MAULDIN. Hedge funds do lose money.

Mr. KANJORSKI. Some very wealthy people sometimes lose a lot of money? They are not guaranteed to make money.

Mr. MAULDIN. That is correct, but I think here again you have the assumption that all hedge funds are equal. We have lumped them into the same class. Some hedge fund are very, very boring, very, very stable. My favorite styles of hedge funds invest in bonds, and they have been able to take out the direction risk of bonds and give their investors very stable returns. You invest in them not because you want to shoot the moon or you are wanting 15 or 20 percent, but because you want a steady 7 or 8 percent. Why shouldn't investors be allowed to do that?

Mr. KANJORSKI. I am not sure it is the role of government to make everything fall under the rule of egalitarianism. I do not recognize that as a capitalistic concept. Generally, capitalism is winners and losers and people that are shrewder make shrewder investments, and they prove their way into the market. I certainly do not want to encourage middle class average families betting their retirement or their kids' funds on a hedge fund because they can get 5 percent more return on their money, possibly. I am not sure that is good public policy.

Mr. MAULDIN. I would reply that the government is already involved. It is involved because it has excluded people from the table. And the second thing is, all the academic studies show that the choices that mom and pop have today for their children's education funds are much riskier than hedge funds. So you are only giving your constituents and voters; you are giving them choices of more risky things. By opening them up to some of the hedge fund strategies that are available to the rich, you would actually be helping them improve their retirements and their college education funds. Right now, they have bad choices.

Mr. KANJORSKI. You would recommend if there is ever a success in privatizing Social Security, we allow these Social Security people to take some of their money and put it in hedge funds?

Mr. MAULDIN. If you privatize it and you would allow them to put their money in stocks or bonds or international stocks, then hedge funds would be appropriate.

Mr. KANJORSKI. So stocks or bonds are riskier than hedge funds? Is that your view?

Mr. MAULDIN. Clearly. Absolutely. I presented the evidence in my statement. We compared bond funds to hedge fund strategies. Again, you have got to be careful when you say "hedge funds." There are dozens of different styles of hedge funds, and some of them are very risky and I would not put French money into them. Some of them are very, very stable, well managed, well run funds.

Mr. KANJORSKI. We just had the commissioner tell us he is not sure he is going to be able to define what a hedge fund is.

Mr. MAULDIN. That is a very good point.

Mr. KANJORSKI. If you are going to have a hard time defining it, we are going to have a hard time keeping people in or out of whatever these 6,000 or 7,000 entities are. Until we can define it, it seems to me we are not in a very strong position to be able to regulate it in a reliable way. Just to open them up for the benefit of allowing middle class people to make a little bit more money; never become wealthy, but make a little bit more money, contingent with how that may be on also losing a great deal more money, I think it is a tough proposition. We have some folks here who are opposed apparently even to short selling. That is too risky.

Mr. MAULDIN. I think short selling is a very risky proposition. Mr. Rocker, I think, will tell you so.

Mr. KANJORSKI. Well, it is risky, but does the government belong in the world of saying you cannot do a risky thing? I mean, it is risky for someone to take a cruise on a cruise liner who cannot swim, but that is not for us to say you have got to administer a test after you buy your ticket and prove you can swim in case the liner goes down. That is a risk of life. They have to be smart enough to protect themselves. Other than that, we are going to have to hire an awful lot of government people to walk around holding the hands of other people who do not want to feel that they have to make these decisions themselves; that it is up to the government to guide them along the way to success or life.Yes?

Mr. LENZNER. We are not saying we want to eliminate short selling. That is not even on the agenda. What we are saying is that there has been a history and a pattern and practice of abuses in the short selling industry, combined with their alliance and working with the plaintiffs bar, which has damaged——

Mr. KANJORSKI. Do you have very clear evidence of that?

Mr. LENZNER. Yes, sir. We have very clear evidence. We have several cases.

Mr. KANJORSKI. How many plaintiffs bar have been disbarred because of that conspiratorial action?

Mr. LENZNER. The plaintiffs bar firm I am talking about today is currently under Federal investigation in the Los Angeles U.S. Attorney's office.

Mr. KANJORSKI. I would imagine anybody who made a statement that there may be a conspiracy would cause a Federal investigation. Investigations do not amount to anything unless there is an indictment and conviction.

Mr. LENZNER. Yes, right, and they are still investigating it.

Mr. KANJORSKI. Yes, but don't hold up because, quote, they are being investigated. Hell, we investigate all kinds of things here. I would hate to conclude that everyone we talk about or investigate is guilty of something improper, wrong, immoral or illegal. That is not the case.

Mr. LENZNER. This practice conducted by the short sellers with the plaintiffs bar has flown under the radar screen. There are only monthly aggregate reports so people do not know exactly what they are doing.

Mr. KANJORSKI. You mean the exchanges and the regulators do not have the authority to examine?

Mr. LENZNER. Of course they do, but my opening statement was this process, these activities have flown under their regulatory radar screen.

Mr. KANJORSKI. Well, you are here now. You are in the public. You are on the record. You have a Congressional Record you can send to the New York Stock Exchange and say here is the testimony I have given. I have incontrovertible evidence. I am available as a witness to testify. I am sure there are some Attorneys General at the State level or at the Federal level that are anxious to make a reputation.

Mr. LENZNER. I hope that is right. I was appearing here hoping to get the interest of the committee to have an oversight relationship with the SEC on this issue because it has gone below the radar screen so long, and because there are numbers of American companies who have been very seriously damaged by misinformation being put out about the company, followed up by litigation which generally can be successful or not successful. I am not defending the companies that have been talked about before; Tyco and WorldCom.

I am talking about companies that are generally not given information about the short sellers except on a monthly basis. They are under short attack. They are not aware of it. They are not aware of information being put out, and they are not aware that the information may be coming from inside their own corporation that is being disseminated outside. So my question for the SEC is, if a short seller is gathering information from a current employee and the information is material and non-public, is that a violation of the inside information rule? I have talked to several senior SEC lawyers.

Mr. KANJORSKI. Is it correct information? Is it true?

Mr. LENZNER. Some of it could be true. Some of it——

Mr. KANJORSKI. Now we are getting very close to First Amendment and privacy rights and everything. I am not sure——

Mr. LENZNER. I do not understand that, congressman. If it is a tip from inside the corporation, it is material non-public information, why isn't that inside information being used to trade and is in violation of——

Mr. KANJORSKI. That is part of the free market methodology of cleaning our markets in a way. I mean, we cannot depend that government or regulators are always going to be able to keep everybody on the top and narrow. But if there is a company out there that is claiming it has product in warehouses and they are empty

warehouses, and one of their inside people tells somebody, that is the market and will penalize that company dearly. I am not sure that I would like to go and say no, we are going to penalize the insider information and we are going to allow that company to continue to have warehouses that have no product that they are representing as product.

You tell which is worse. I think having companies that have a gag rule on everything and can perpetuate all kinds of frauds would be worse than having a short selling operation; I think you have to worry. If you are a CEO and you are pulling some gimmick, you better be darn certain how few people know about it. If enough people know about it in your company and it is going to leak out, and you are going to get raided in a short sale, that is your problem. That is good enforcement. That is the capitalist market. You got stuck. We did not have to spend one cent for a prosecutor. We did not have to send the FBI down. We did not have to do anything. You just got cleaned.

Mr. LENZNER. What is the difference between that and the investigation of Martha Stewart for when she was on a long position selling because she has heard the stock is going down?

Mr. KANJORSKI. I do not have a lot of sympathy for the crucifixion of Martha Stewart.

Mr. LENZNER. I am just saying, what is the difference between investigating her for that and investigating a short seller who does exactly the same thing?

Mr. KANJORSKI. I doubt very seriously if her name were not Martha Stewart there would have ever been an investigation.

Mr. LENZNER. All I am trying to do is show an example of an investigation into somebody who traded on a long position; why should that be any different than somebody who traded on a short position?

Mr. KANJORSKI. It should not be any different, but unfortunately if you are; who is that crazy guy Jackson; you know, you just have to do a crazy thing and put a mask on and you make headlines. If I did the same thing he did the other day, nobody would pay any attention to it. That is just; we cannot get into regulating and controlling that. I hope we do not, because we are going to need so many people working down at the SEC there are going to be more employees at the SEC than there are investors.

Chairman BAKER. Let me jump in. Let me try to put all of this into a basket and I will recognize you. I think it is clear from the comments of the Chairman this morning, of the SEC, we are operating in a fashion that is clearly handicapped. We do not have enough information, I do not think, to make decisive determinations about, one, whether additional disclosure should be required; whether the regulatory environment is or is not adequate; whether or not there are manipulative forces at work on this side of the ledger. We have not as a committee ever examined this subject before. Today's hearing is not to reach an end determination, but to begin a lengthy process of examination. While we await the SEC's initial report, hopefully either before or just after the August recess, at which time I think we need to really delve into the issue of separating the hedge funds from the hedge hogs. That is what this is all about.

There has been an enormous growth in the market. There are significant growth in resources being invested. And there are pension funds pouring money into these activities, which appear to be somewhat veiled and if not transparent, they may be translucent even to the smart, sophisticated investor, and we have work to do. I do not dispute at all what Mr. Kanjorski is saying. We do not want to be in the business of running hedge funds as a SEC or as a Congress for sure. There is a vital role for them, but we would have some action for our own constituents to look at us rather caustically if we were not to conduct this examination, given the enormity of their appearance in the marketplace.Yes, Mr. Rocker?

Mr. ROCKER. Yes, I would just like to say a couple of things. The growth of hedge funds is not something that is stimulated by hedge funds seeking clients, but conversely by clients seeking hedge funds.

Chairman BAKER. You make my point, and that was the same reason for the growth in the equity market. It was not the fact that the equity people were out there necessarily dialing up everybody. You had lots of folks with cash in the bank or even worse, borrowing money at 8 percent and investing it because they did not want to miss the 20 percent rise.

Mr. ROCKER. That is right.

Chairman BAKER. What we want to ensure is that we have enough knowledge that that same effect is in fact not occurring on the other side of the ledger sheet.

Mr. ROCKER. Right. I do want to state for the record that there are a lot of things which are not subject to conjecture, but are empirical fact. Hedge funds have out-performed mutual funds. They have been more safe. They have in fact on a collective basis had much lower volatility, and so perhaps the smaller investor should have an opportunity to invest in hedge funds in an appropriately regulated fashion, if that is Congress' will. But there is not an issue of how they performed. Number two, with respect to longs spreading false rumors versus shorts spreading false rumors——

Chairman BAKER. Let me jump back to that first conclusion. There is no question that hedge funds are functioning properly. In a broad, categorical statement, yes; as hedge fund to hedge fund, there may be questions.

Mr. ROCKER. For sure. But as far as not knowing what the industry is or its size, there are large indices. For instance, CS FirstBoston Tremont has an index which covers about 80 percent of the assets. Those are where the statistics are coming from. So you may miss a little, but you certainly know what is happening with most. It is as good as the Investment Institute.

Shorts are a convenient scapegoat after a market has cost investors $7 trillion. The point that I was trying to make in my statement, and I wish to reiterate now, is that we should be looking at what got us to the level from which people lost so much money. The biases are entirely on the side of the bulls. Regulations are in place which allow any fraudulent activity, whether it be by a short seller or long, to be subject to prosecution. They should be aggressively pursued. But the record is clear, the prosecutions and more importantly the findings of such has overwhelmingly been on the

side of longs pushing bogus stocks as opposed to shorts spreading bad stories.

I would invite anybody who doubts this to look on the Web sites and chat boards of the Street to find people who are hiding behind anonymous names who, by the way, include corporate officers spreading positive stories about their own stocks. It is a wholly biased field. To the extent that you further restrict the very few people who are willing to go at risk, the short sellers, with their own capital, I believe you would be making a great mistake and risking the public savings of this nation to a greater degree.

Chairman BAKER. Thank you, Mr. Rocker. Mr. Kamenar?

Mr. KAMENAR. Mr. Chairman, I just wanted to make a point about the transparency issue that was raised about information. I think we all agree that transparency is a good thing. In 1991, the House Government Operations Committee, as I stated in my written testimony, recommended that daily and weekly short selling data activity and interest be obtained from broker dealers and be made available electronically; daily and weekly activity at a minimum.

This is in 1991 that the Government Operations Committee recommended that. Yet today, it is a 30-day or monthly report, and during that monthly period, as Mr. Lenzner testified, a lot of short activity could be going on that the CEO or the company and other investors do not know about. The committee also issued a report in 1991 on short selling and agreed that the SEC's uptick rule was valuable as a price stabilizing force, and encouraged Nasdaq to adopt a similar restriction, which they did in 1994.

So there are certain things that the committee and the Congress can do that assists investors to stabilize the market without necessarily being the nanny state for certain unsophisticated investors.

Mr. ROCKER. That is all part of the asymmetry of the market. There is an uptick rule preventing sellers from selling it down. There is not a downtick rule preventing buyers from cascading stocks up, especially in today's electronic marketplaces where you can use ECNs to sweep markets at various levels. That is what got stocks to 130 times earnings for the Nasdaq 100. That is when the mutual funds were sucking in a tremendous amount of the savings of this nation which was subsequently destroyed. That is what should be investigated.

Chairman BAKER. You gentleman have raised a panoply of issues which are going to take us some while to unwind, if it is possible. Since we are talking about something we cannot define that nobody seems to regulate, that nobody can explain how they performed so well, for which so many dollars are invested, we have got a lot of homework ahead of us.

Let me express my appreciation for your longstanding patience in the hearing today. The bells have just gone off for votes on the floor, but the committee would reserve the right to forward additional questions, particularly in light of Mr. Kanjorski's line of questioning on specifics of allegations relating to activities that each of you might have raised from different perspectives. We look forward to working with you in the months ahead toward resolution of this important matter.Thank you very much.

[Whereupon, at 1:02 p.m., the subcommittee was adjourned.]

A P P E N D I X

May 22, 2003

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk
May 22, 2003

Thank you Chairman Baker for holding this important hearing. The growth of the hedge fund industry makes it incumbent upon this Committee to examine whether there are sufficient investor protections currently in place. Pursuant to the Committee's ongoing efforts to restore investor confidence, we are reviewing the financial products in our marketplace to ensure that investors are being treated fairly and appropriately. Some have argued that hedge funds are not an appropriate investment for retail investors; others suggest that all Americans should be given access.

Some have raised concerns about the lack of transparency in this industry, given its size, scope, and impact on the markets. Our review of this industry will help us determine whether additional regulatory scrutiny is warranted, or whether additional regulations would actually harm investors and the markets.

Indeed, hedge funds have served their investors well throughout the recent bear market. The average hedge fund has recorded impressive gains in these difficult markets, and done so with less risk than the average mutual fund.

The industry has experienced considerable growth over the past decade, increasing in size from approximately $50 billion in assets to about $600 billion today. In just the past five years, the number of funds has doubled, with about 3,500 new hedge funds opening for business. This explosion in growth has been fueled by good performance and growing interest from large institutional investors such as pension funds, charitable foundations, and university endowments.

Concerns have been raised that many financial services companies – trying to capitalize on the exceptional performance of hedge funds – have begun to market portfolios of hedge funds to retail investors. These "funds of hedge funds" are registered investment companies that typically invest in 20-30 hedge funds. They usually require lower minimum investments than traditional hedge funds. It is my understanding that these financial products – which have been available to institutional investors for some time – are only being sold to investors who meet the income or net worth requirements of traditional hedge funds.

But while hedge funds are currently being sold only to "accredited" investors, it is my understanding that the funds of funds are only doing so because they do not wish to sell to retail investors. There may be a concern that, given the lack of a statutory restriction, they could, in the future, change their guidelines and sell to retail investors. I look forward to learning from Chairman Donaldson what the Commission has found thus far regarding the access to hedge funds by these investors. Some question why retail investors are being denied access to these important financial risk-balancing tools simply because they are not wealthy. Today's panel will help illuminate this debate.

Some have raised concerns about short-selling and its potential use to manipulate the market. I am pleased that the Commission is examining these issues in its ongoing review of hedge funds and the markets and I look forward to hearing the views of Chairman Donaldson and our other witnesses on the effectiveness of existing laws prohibiting such activity.

I applaud the SEC's year-long review of hedge funds and eagerly await the forthcoming staff report. There are many important investor protection and capital formation issues to be addressed. This Committee, and the Commission, must proceed with an abundance of caution as we examine this industry, which has served its investors well and provides important benefits to the markets.

###

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"
May 22, 2003

GOOD MORNING, MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, AND WITNESSES.

I CONGRATULATE THE SEC'S RECENT ANNOUNCEMENT THAT A REVIEW OF HEDGE FUNDS AND SHORT SELLERS WAS UNDERWAY.

THERE IS A NEED FOR GREATER TRANSPARENCY THROUGH DISCLOSURE TO INVESTORS, MARKET PARTICIPANTS AND CREDITORS TO MORE ACCURATELY ASSESS THE RISK OF THE ACTIVITIES OF A HEDGE FUND. IN LIGHT OF THE IRREGULARITIES OF THE PAST FEW YEARS, WE KNOW THAT IT IS NECESSARY TO HAVE SOME DISCLOSURE AS THE MARKET DOES NOT ADEQUATELY REGULATE ITSELF.

PRACTICES OF SOME OF THE SHORT SELLERS ARE TACTICS ONE WOULD EXPECT TO FIND IN SOME LAWLESS, UNREGULATED, PLACE FAR REMOVED FROM THE UNITED STATES OF AMERICA. SOME SHORT SELLERS USE PRACTICES OF FALSE ACCUSATIONS OF CRIME ASSOCIATIONS, QUESTIONABLE ACCOUNTING PRACTICES, THREATS OF BANKRUPCTIES ALL FOR THE PURPOSE OF DEPRESSING PRICES. WE HAVE TO HAVE BETTER CONTROL OF THE SITUATION THAN THIS. THIS IS ALLOWING MARKET MANIPULATION.

THIS SPREAD OF FALSE INFORMATION IS MADE EASY BY THE USE OF THE INTERNET. SELLERS AND OTHER INTERESTED PARTIES CAN INSTANTLY SPREAD DAMAGING INFORMATION AND CAUSE DRASTIC REDUCTIONS IN PRICES OF SECURITIES IF NOT MONITORED.

THE TREMENDOUS GROWTH OF THE "HEDGE FUNDS" IN THE LAST FEW YEARS HAS EXCEEDED ANYONE'S EXPECTATION OR ANTICIPATION. THE MANNER OF OPERATION OR TRADING STRATEGIES OF THESE FUNDS HAS CHANGED ALONG WITH THE INCREASE IN THEIR SIZES. THE NAME HAS ALSO BECOME A UNIVERSAL NAME FOR THE MANY UNREGISTERED, PRIVATELY-OFFERED, MANAGED POOLS OF CAPITAL. THE RULES, OR LACK OF REGULATION, GOVERNING HEDGE FUNDS ARE SORELY OUTDATED OR AT THE LEAST, ARE IN TREMENDOUS NEED OF REVIEW.

MR. CHAIRMAN I ASK UNANIMOUS CONSENT TO SUBMIT MY STATEMENT TO THE RECORD.

May 22, 2003

Honorable Rahm Emanuel
United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Re: Hearing on "the Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

- Mr. Chairman, I want to commend you for holding this important hearing on the role hedge funds play in the financial markets.
- I'd also like to welcome Chairman Donaldson and our other distinguished witnesses.
- I've had a longstanding interest in the subject of today's hearings, going back to my service in the White House when the Long-Term Capital crisis occurred, and subsequently as an investment banker and private investor.
- More recently, I've discussed my opinion with members of this Committee and SEC on the need for Congress to assess whether the current regulatory framework provides adequate investor protections, especially for retail investors and pension funds.
- Last week, I had the opportunity to attend the SEC's Roundtable on Hedge Funds. Chairman Donaldson and his team put together an excellent program by gathering a wide spectrum of industry participants and observers.
- We in the Congress also have a responsibility to, as Chairman Donaldson said, "take a long, hard look at hedge funds," especially in view of the industry's rapid growth, the increase in hedge funds' share of overall market trading volume, a spike in fraud cases, and the "retailization" of hedge fund products.
- As this Committee begins to gather information on the hedge fund industry, there are some fundamental questions we need to have addressed:

1) To what extent is the "retailization" of hedge funds a real problem? After the Roundtable, Commissioners Glassman and Campos said retailization is no longer one of their concerns.

2) Should the SEC require clear disclosures that address certain basic investor protection issues such as: conflicts of interest, valuation, performance reporting, relations with prime brokers and other service providers, investment allocation policies?

3) Should Congress and the SEC be focused on distinctions between "accredited investors" and ordinary investors, or on the level of disclosure/transparency of information, or both?

4) Is the recent spike in hedge fund fraud cases the result of a few bad actors, or is this a sign of widespread abuse (cite the week's *Business Week* article)?

5) Finally, I'd like to hear from the panels on systemic risk issues. As hedge funds' share of the markets overall trading volume increases (Now more than 25% of all trades), what unique risks are posed? Additionally, has market surveillance by regulators and counterparties improved enough since LTCM to uncover excessively leveraged hedge funds?

- Clearly, many hedge funds and funds of hedge funds have historically served their investors well and have made positive contributions to the markets.

- Many hedge funds are non-correlated with the equity markets and thus reduce portfolio risk while providing diversification. Others, like those focused on short-selling, play a valuable "watchdog" role, having exposed both overvalued and fraudulent companies such as Tyco and Enron.

- But it's critical that investors, particularly retail investors and pension funds, receive the information they need to be able to assess risk, make informed decisions, and evaluate their investments on an on-going basis.

- I have the largest number of Illinois' police, firefighters and teachers in my district, and I'm concerned that the current disclosure scheme may not be providing pension managers with adequate information. This is especially important in light of the fact that many pension funds now invest upwards of 5% of their capital in hedge funds. With the prolonged downturn in the markets, we also have retail investors flocking to hedge funds to try to make up for lost returns.

- Therefore, if hedge funds are going to be accessible to retail investors and pension funds, and are going to be marketed to those parties, it seems to me that we need to set some standards---not necessarily to restrict investors' access, but to provide information in "plain English" to help people make good decisions—-and I also think hedge fund managers should be held to the same "lock-up" periods and trading restrictions as the funds' other investors.

- I'm eager to continue working with my colleagues and the SEC to assure that investors receive the information they need to make informed investment decisions.

Thank you, Mr. Chairman.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK

THURSDAY, MAY 22, 2003

Mr. Chairman, we meet today for the first time since our subcommittee considered legislation in 2000 in response to the collapse of Long Term Capital Management to explore the issue of hedge funds. Created more than five decades ago, hedge funds have largely operated on the periphery of our nation's capitalistic system with limited regulatory oversight, restricted investor access, and little public disclosure. Nevertheless, hedge funds, in my view, have played an important and crucial role in the ongoing success of our capital markets.

Before we hear from our witnesses, it is important to review some basic facts about the size and scope of the hedge fund industry. Today, experts estimate that there are between 6,000 and 7,000 hedge funds operating in the United States. The hedge fund industry has also grown substantially in recent years. According to several estimates, hedge funds managed $50 billion in 1990, $300 billion in 2000, and $650 billion in 2003. Moreover, although hedge fund holdings represent about four percent of the value of the stock market, the *Wall Street Journal* recently reported that hedge fund trading accounts for nearly a quarter of the daily volume.

As our capital markets have continued to evolve in dramatic ways during the last decade, hedge funds have attracted the attention of many of our nation's investors, particularly those who want to earn higher returns in today's chaotic markets. Because of their entrepreneurial investment strategies and their independence from the legal requirements applied to other securities products, hedge funds can generate positive returns even during bear markets.

Additionally, hedge funds have attracted the attention of our regulators. In February, for example, the National Association of Securities Dealers issued a notice to brokers reminding them of their obligations when selling hedge funds. Last year, the Securities and Exchange Commission also began a comprehensive review of a number of issues related to hedge funds, including their recent growth, trading strategies, regulatory oversight, and transparency. In its investigations, the Commission has also worked to examine the retailization of hedge funds.

As my colleagues know, investor protection is a top priority for my work on this panel. From my perspective, a hedge fund is a very sophisticated securities instrument. As a result, only very sophisticated individuals with adequate resources and sufficient diversification should purchase this type of product for their portfolios. Hedge funds also have successfully operated with little regulatory scrutiny for many years, and we should not now add additional layers of unnecessary regulation in order to further protect those investors who are truly qualified to make these investments and already fully understand the risks involved.

As we consider these issues, I would further encourage my colleagues on both sides of the aisle not to make quick judgements about changing the statutory and regulatory structures governing the hedge fund industry. Unless we identify something wrong, something that

endangers our capital markets, something that poses a systemic threat for our financial institutions, or something that represents bad public policy, we should defer action in this area and await the recommendations of the experts at the Securities and Exchange Commission and elsewhere. We additionally must move forward prudently and carefully in our investigations in these matters in order to ensure that we do not cause further disturbances in our already turbulent capital markets.

Finally, later this morning I expect that we will hear complaints about short selling, a strategy used by a number of successful hedge fund managers. I believe that this practice provides investors with an opportunity to use the information that they have about a particular company, industry, or financial instrument to make money. This practice, in my view, is therefore a useful investment technique. It also helps to provide needed liquidity to our capital markets. Furthermore, it is perfectly legal. In short, when fairly practiced, short selling is an important offshoot of capitalism, and we should not unnecessarily limit this practice.

Mr. Chairman, I want to commend you for bringing these matters to our attention. I look forward to hearing from each of our witnesses, especially Chairman William Donaldson who is testifying before us for the first time since he took over the helm at the SEC. I have already found his insights valuable and his leadership respected. With that, Mr. Chairman, I yield back the balance of my time.

TESTIMONY

OF

WILLIAM H. DONALDSON, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MAY 22, 2003

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk

William H. Donaldson

Chairman, U.S. Securities and Exchange Commission

Before the

Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

United States House of Representatives

May 22, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

Thank you for inviting me to testify today to discuss hedge funds generally and the Securities and Exchange Commission's ongoing fact-finding review of hedge funds. As you know, the Commission hosted a two-day Roundtable on hedge funds last week. The event was a great

success and proved to be informative and lively. We had terrific public turnout for the event and a large number of listeners on the webcast, which highlights just how important hedge funds have become. As I said at the close of the Roundtable, it was an excellent example of how the SEC can operate as an effective regulator, by assembling a highly knowledgeable group of experts representing a variety of viewpoints to debate important issues. I appreciate having the opportunity to discuss the Roundtable and our fact-finding review of hedge funds with you.

Fact-Finding Mission and Roundtable

The Commission embarked on a fact-finding mission last year to look into hedge funds. The Commission's Division of Investment Management, alongside our Office of Compliance Inspections and Examinations, has been gathering information on a variety of investor protection issues associated with hedge funds. The staff obtained and reviewed documents and information from 67 different hedge fund managers representing over 650 different hedge funds and approximately $162 billion under management. The staff also visited and engaged in discussions with a number of different hedge fund managers.

As a complement to our inquiries directed to specific hedge funds, the staff has met with a variety of experts, consultants, academics and observers

of the industry to get their perspectives on the hedge fund industry. In addition, a number of foreign jurisdictions are revisiting their approaches to the regulation of hedge funds, and we continue to benefit from discussions with our foreign counterparts.

Participating in our Hedge Fund Roundtable were hedge fund managers, consultants, service providers (such as auditors and attorneys), academics, prime brokers, investment bankers, investors and foreign and U.S. regulators. These experts discussed key aspects of hedge fund operations – how they are structured and marketed, investment strategies they use, how they impact our markets, how they are regulated, and whether the regulatory framework should be modified.

I want to stress that the Roundtable was not the culmination of our fact-gathering and that we have not yet reached any conclusions. I have asked the SEC staff to prepare a report to the Commission on the results of our various fact-finding efforts. Additionally, we have called for public comment on the issues surrounding hedge funds. The public comment period will close approximately 45 days from today, on July 7th. I have asked the staff to consider these views when preparing the staff report, which will be delivered to the Commission, with the intention of making it publicly available shortly thereafter.

So, while it is too early to draw any conclusions or make recommendations about the regulation of hedge funds, I do want to share with you some of the issues and areas of interest explored during the Roundtable, including (1) growth of hedge funds, (2) hedge fund trading strategies and market impact, (3) trends in the hedge fund industry, (4) the differences between hedge funds and registered investment companies, (5) hedge fund fraud, (6) the regulatory framework applicable to hedge funds, and (7) investor education.

Growth of Hedge Funds

One of the reasons the Commission determined to embark on its fact-finding mission is because of the tremendous growth of hedge funds. Over the past few years, the number of hedge funds and their assets under management has continued to increase. As was reiterated last week at the Roundtable, there are no precise figures available regarding the number, size and assets of hedge funds. This is due, in part, to the fact that there is no industry-wide definition of hedge fund; in part, because those that track hedge fund data rely on self-reporting by hedge funds; and in part because hedge funds generally do not register with the SEC, so we cannot independently track the data.

Nonetheless, during our Roundtable, knowledgeable sources confirmed that there are between 6,000 and 7,000 hedge funds operating in the United States today with approximately $650 billion under management. To put this number in perspective, today there are approximately $6.3 trillion of assets under management in the mutual fund industry. Over the past few years, the panelists estimated that there has been, on average, approximately $25 billion a year in new assets invested in hedge funds. One panelist estimated that, in the next decade, assets under management in hedge funds will top $1 trillion.

Hedge Funds and Their Trading Strategies

As was noted in the Roundtable, the term "hedge fund" is undefined, including in the federal securities laws. Indeed, there is no commonly accepted universal meaning. As hedge funds have gained size and popularity, though, "hedge fund" has developed into a catch-all classification for many unregistered, privately-offered, managed pools of capital, generally excluding, in particular, funds principally involved in venture capital or similar private equity investments. This is, I believe, a far cry from the original concept of hedge funds in the early 1950s, when hedge funds characteristically were long/short equity funds that engaged in fundamental hedging strategies.

Hedge funds today engage in a wide variety of trading strategies based on mathematical models, as well as strategies developed to take advantage of perceived market inefficiencies. There are hedge funds focused on equity strategies, others focused on fixed income strategies, and still others focused on a combination of the two. Panelists said that hedge funds are net providers of liquidity to the markets, and that they are active and informed traders whose research fosters more accurate market prices, and so they play an important role in promoting efficient pricing of financial instruments.

Panelists noted that trading by hedge funds is subject to the same market rules as other traders, although some strategies may be more accessible to, or feasible for, hedge funds than to regulated entities. While hedge funds sometimes engage in substantial short selling, that activity usually reflects a belief that a company is overvalued, or is part of a hedging strategy. It was also pointed out that short selling is subject to greater regulation, at least in exchange-listed stocks, than most other trading activities. Moreover, if short sellers make false statements about issuers for the purpose of lowering their stock prices, that conduct is actionable under the anti-fraud and anti-manipulation provisions of the federal securities laws.

There was some debate about whether hedge funds present systemic risk to the markets. It was noted that there are some market-driven controls on the risk that hedge funds can take. For example, firms that supply prime brokerage services to hedge funds said that they protect themselves by carefully screening them for business model consistency, credit quality, leverage, and other areas of risk management. However, a prime broker is not necessarily aware of all of a hedge fund's activity. Some panelists stated that volatility in hedge funds was less than that of stocks. Others noted that, while volatility may be lower and relatively few hedge funds have failed, some strategies used by hedge funds have led to spectacular failures that could threaten the financial system, notably Long Term Capital Management. One participant recommended that the Commission analyze every hedge fund failure to identify possible causes to alleviate systemic problems.

Trends in the Hedge Fund Industry

Roundtable panelists explored trends in the hedge fund industry. These trends included not only an increase in the number of hedge funds and the assets of those hedge funds, but also an increase in the number and type of institutions, such as pension plans and endowments, investing in hedge funds and a continuation of the entrepreneurial management that has been a

hallmark of hedge funds. According to our panelists, the institutional investors that are placing a portion of their assets with hedge funds typically are very sophisticated and perform extensive due diligence prior to investing, often taking months to research a hedge fund before making an investment. As with many of the panelists' positions, the Commission and staff are, of course, not currently in a position to verify their assertions.

Another trend involves so-called "retailization" and the recent emergence of registered funds of hedge funds. These are registered investment companies that invest all, or substantially all, of their assets in an underlying pool of hedge funds. These products offer a means of increased availability of hedge funds to public investors. The Commission's Division of Investment Management has seen a boom in these funds. In the summer of 2002, the first fund of hedge funds became eligible to sell its securities to the public. Subsequently, there have been approximately 19 other funds of hedge funds cleared for the public market.

All of these funds currently have minimum investment requirements of at least $25,000. Also, these funds currently limit their investors to accredited investors (i.e., investors with an income for the last two years of $200,000 or net worth of $1 million). But, there is currently no federal requirement for a minimum investment or for limiting eligible investors, and

it is likely that funds might seek to lower these requirements, thus making these types of funds available to a greater number of investors with less capital. As was discussed at our Roundtable, the emergence of these products also implicates the need to focus on suitability determinations and sales practices of those marketing hedge funds and funds of hedge funds.

Funds of hedge funds raise special concerns because they permit investors to invest indirectly in the very hedge funds in which they likely may not invest directly due to current legal and regulatory restrictions. Many of our Roundtable participants noted that registered funds of hedge funds, because of their size and influence, can compel the underlying hedge funds to provide more information to investors than they would typically receive. However, even funds of hedge funds do not get the same volume and frequency of information as investors in a registered investment company or mutual fund. Investors in these funds receive very little information on an on-going basis regarding the underlying funds and, because the underlying hedge funds are not subject to our examination authority, we have very little information regarding them as well. Our further work in this area will include consideration of the type and level of information available to funds of hedge funds, and their investors, from the underlying hedge funds.

Prime Brokers. As I mentioned earlier, another trend discussed at the Roundtable was the importance of the role of prime brokers. Hedge funds generally use one or more broker-dealers, known as "prime brokers," to provide a wide variety of services.

Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades, and other aspects of portfolio management, for substantial retail and institutional customers including, especially, those who are active market participants. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The prime broker is the broker-dealer that clears and finances the customer trades executed by one or more executing broker-dealers at the behest of the customer. The prime broker is responsible for all applicable margin and Regulation T requirements for the customer.

Generally, customers, such as hedge funds, believe a prime brokerage arrangement is advantageous because the prime broker acts as a clearing facility and a source of financing for the customer's securities transactions wherever executed, as well as a central custodian for all the customer's securities and funds.

Prime brokers offer certain other services to hedge funds that are typically offered to other substantial customers such as margin loans and risk management services, but prime brokers may also offer other services that are particularly directed to their hedge fund customers. For example, some prime brokers provide "capital introduction" services to hedge funds. These services, which range from sponsoring investor conferences to arranging individual meetings and preparing informational documents, are aimed at bringing hedge fund managers together with potential investors. We are looking into these services, their impact and the manner in which they are disclosed to investors.

Differences between Hedge Funds and Registered Investment Companies

Trading Strategies. Several of our Roundtable participants focused on comparing and contrasting hedge funds with registered investment companies. For example, one panel explored how hedge fund investment and trading strategies compared with mutual fund investment and trading strategies, particularly in terms of risk. This panel also explored whether, because hedge funds are not subject to the liquidity, diversification and senior security coverage requirements imposed on registered investment companies, they increase their potential exposure to market fluctuations. On the flip side, the panel also considered whether the current investment,

leverage and redemption limitations imposed on registered funds through the Investment Company Act of 1940 are too restrictive and whether the growth of unregistered funds is due in part to these restrictions on registered funds.

Performance Fees. Panelists reviewed the differences in compensation structures for mutual fund managers and hedge fund managers. One of the predominant characteristics of hedge funds is that hedge fund managers typically receive a performance fee. In addition to a 1-2% management fee, the general partner or manager of a hedge fund usually also shares in any profit of the hedge fund. A typical performance arrangement provides that the manager will receive a certain percentage-- typically 20% -- of the net appreciation of the fund in excess of a specified benchmark. Mutual funds, on the other hand, are limited to a type of performance fee known as a "fulcrum fee" in which the manager is compensated for performance above an index, but is correspondingly penalized for performance below an index. According to panelists, only a small number of mutual funds, estimated at less than 2%, have fulcrum fees.

Some of our institutional investor panelists noted that performance fee arrangements align the interests of the hedge fund manager with the investors, as the manager's compensation structure provides a monetary incentive to perform well. It should be noted that performance fees of the

types generally used in hedge funds align manager and investor interests on the upside but not on the downside. Some panelists also indicated that it was important to them that the hedge fund manager have a significant portion of his or her personal net worth invested in the hedge funds to further align their interests.

Hedge fund performance fees also raise a conflict of interest issue when an investment adviser manages both a hedge fund and a mutual fund or some other kind of account without a performance fee. The adviser has an incentive to allocate the best trades, ideas and attention to the hedge fund because of the potential to increase the performance fee. Roundtable panelists generally agreed that this situation does raise a conflict of interest that requires appropriate disclosure, allocation and other procedures on the part of the adviser.

Performance Reporting. Another area of comparison focused on performance reporting. Mutual funds must report their performance in a standardized format, meant to enable an investor to make meaningful comparisons between different mutual funds. Currently, there are no requirements dictating how a hedge fund should report its performance. Some of the Roundtable panelists suggested that it might be helpful for hedge funds to have standardized performance reporting, although I should

note that the marketplace itself has taken steps in analogous situations to address the issue of standardized performance reporting.

Valuation. Related to performance reporting is the issue of valuation. The Roundtable featured a lively discussion of valuation of hedge fund holdings. Registered investment companies must price their portfolio securities at market or, if there is no reliable market price, at their current "fair value" – determined in good faith by the fund's board of directors. Hedge funds are not specifically subject to these requirements. Thus, for example, hedge funds may determine that the appropriate price of a security is its inherent price, a price that looks to the future. Or it may substitute the manager's determination of the value of a security for a market price. Valuation determinations can be further complicated by the fact that hedge fund portfolios may have a large number of illiquid securities in them about which valuation information is further limited, thereby making the manager's valuation all the more subjective.

These valuation determinations are, of course, subject to the antifraud provisions of the federal securities laws. Ultimately, it may be impossible for an investor to know the actual value of a hedge fund's portfolio securities. Panelists did note, however, that the hedge fund industry is

moving in the direction of involving independent third parties in the valuation of hedge fund assets.

Finally, some panelists observed that a hedge fund adviser's timing of disclosing changes in valuation, including substantial decreases, is subject to general anti-fraud principles.

Disclosure and Transparency. Performance fees and valuation raise the broader issue of disclosure and transparency generally. Panelists discussed the nature of hedge fund disclosure through the private placement memorandum, compared to the mandated disclosure provided in a registered investment company's prospectus. Many agreed that there is room for disclosure improvement on both fronts but that much could be done to improve the usefulness of the private placement memorandum. Panelists also discussed the need for increased transparency, particularly of hedge fund risk characteristics, as opposed to portfolio position disclosure. Finally, some panelists discussed the need for ongoing disclosure to investors, in addition to the disclosure received when making the initial investment decision.

Hedge Fund Fraud

Fraud is, of course, always a primary concern to us. I emphasize that I am not suggesting that hedge funds or their managers engage

disproportionately in fraudulent activities. Indeed, some at our Roundtable, including the CFTC, which oversees futures trading activities of that portion of the hedge fund universe that operate as commodity pools, asserted that commodity pools, especially large commodity pools, have been relatively free from major frauds.

However, the Commission has seen an increase in the number of hedge fund frauds that we have investigated and that have resulted in enforcement action. In fact, last year we instituted 12 hedge fund related enforcement actions, which was almost twice the number of enforcement actions against hedge funds or their managers than we instituted in any of the four previous years, having instituted 7 hedge fund actions in 2001, 6 in 2000, 2 in 1999 and 1 in 1998.

Examples of charges filed by the Commission include:

making false or misleading statements in offering documents;
misappropriating assets;
market manipulation in a variety of guises;
reporting false or misleading performance, including with respect to valuation of securities; and
fraudulently allocating investment opportunities.

These charges generally are not unique to hedge funds, and fraud may not be more prevalent at hedge funds. But hedge funds present us with a unique challenge. Because hedge funds typically are not registered with us, we are limited in our ability to detect problems before they result in harm to

investors or the securities markets. We will continue to come down hard when we see fraudulent activities involving hedge funds, or any investment entity, and I would disabuse any fraudsters who might believe that hedge funds provide a safe haven for engaging in fraudulent or manipulative activity.

Regulation of Hedge Funds under the Federal Securities Laws

As was noted at our Roundtable, the exclusions from registration under the federal securities laws that apply to hedge funds and their securities offerings are central to the questions that currently surround hedge funds. The exclusions define the investment strategies that hedge funds may pursue, the types of investors who generally may invest in hedge funds, and how hedge fund securities may be sold. Hedge funds are able to avoid regulation by meeting criteria that are laid out in four general exclusions or exceptions: (1) the exclusion from registration of the fund under the Investment Company Act of 1940, (2) the exemption from registration of the fund's securities under the Securities Act of 1933 (3) the exception from registration of the hedge fund manager under the Investment Advisers Act of 1940, and (4) the exception from reporting requirements under the Securities Exchange Act of 1934.

Exclusion from Registration under the Investment Company Act of 1940. Hedge funds typically do not register with the SEC. They rely on one of two exclusions under the Investment Company Act of 1940 to avoid registration. The first exclusion under Section 3(c)(1) of the Investment Company Act limits investors in the hedge fund to 100 persons, while the second exclusion under Section 3(c)(7) of the Investment Company Act, which was added to the Investment Company Act in 1996, imposes no numerical limit on the number of investors.[1] Instead, it generally looks to the size and nature of the investments of an individual. Thus, investors in funds that utilize the 3(c)(7) exemption generally must be "qualified purchasers." Qualified purchasers are defined to include high net worth individuals (generally individuals who own certain specified investments worth at least $5 million) and certain institutional investors. The operating principle behind 3(c)(7) is that sufficiently wealthy investors do not need the full protections of the registration provisions of the federal securities laws.

Exemption from Registration under the Securities Act of 1933. Importantly, both of these exclusions require hedge funds to sell their securities in non-public offerings. Thus, most hedge funds rely on one of a

[1] Although there is no specific numeric limitation on the number of investors in a Section 3(c)(7) fund, the federal securities laws generally require any issuer with 500 or more investors and $10 million of assets to register its securities and to file public reports with the Commission. Most hedge funds do not wish to register their securities, and therefore they stay below the 500 investor level.

handful of exemptions under the Securities Act in order to avoid making a public offering. In order to be classified as a non-public offering, the hedge fund securities may not be offered for sale using general solicitation or advertising. Additionally, hedge funds generally sell their securities only to those who qualify as "accredited investors." The term "accredited investor" includes individuals with a minimum of $200,000 in annual income or $300,000 in annual income with their spouses, or a minimum, with their spouses, of $1,000,000 in net assets. It also includes most organized entities with over $5,000,000 in assets, including registered investment companies.[2]

Because these limitations under the Securities Act apply at lower levels than the "qualified purchaser" exemption for 3(c)(7) funds, these 3(c)(7) funds may only be offered or sold to investors who are qualified purchasers as well as accredited investors. Other hedge funds, that do not qualify as 3(c)(7) funds, including 3(c)(1) funds, may be offered and sold to accredited investors, whether or not they are also qualified purchasers.

The monetary amounts used to determine accredited investor status essentially have remained the same since 1982. With the sustained growth in incomes and wealth in the 1990's, however, more investors meet this

[2] This exemption also permits a private issuer to sell to up to 35 non-accredited investors, but in that case, those investors must be "sophisticated" persons – meaning that they must be capable of evaluating the merits and risks of their investment – and the issuer must provide disclosure to those investors comparable to that in public offerings.

standard, despite recent economic downturns. Although the Commission is not aware of any systematic investor losses or other failures caused by the current accredited investor standard, we could of course consider adjusting it, if warranted. In that respect, it may be appropriate to consider whether the definition should be updated to increase the levels of income or assets. It also may be anachronistic to use the definition as a surrogate for investor sophistication, and it may also be worthwhile to revisit that concept. A global change to the standard, however, could impact significantly the availability of securities registration exemptions to other companies. In particular, we would carefully consider the effect of any adjustment to the standard on the opportunities for small business capital formation before proposing any change.

In addition, the Internet has changed forever how companies communicate with their current and prospective investors. Just plugging the term "hedge fund" into any search engine will elicit hundreds of responses. If hedge fund sponsors fail to follow the law, every investor with access to the Internet could easily obtain materials that could constitute an offering of securities to the public, triggering registration and other requirements under the securities laws. Appropriate regulation of Internet offerings is a challenge for the Commission, as it is for other regulatory agencies. The

Commission staff watches how the Internet is used to offer securities to the public, including offerings by hedge funds. Our policy goal is to strike a balance between encouraging use of the Internet for legitimate capital formation and at the same time preventing fraud and abuse. If we become concerned that our rules and guidelines need to be changed, or enforcement action needs to be taken, to prevent abuse by hedge funds or others engaged in purported capital formation activity, we will act accordingly.

Exception from Registration under the Investment Advisers Act of 1940. Managers of hedge funds meet the definition of "investment adviser" under the Investment Advisers Act of 1940 because they are in the business of providing investment advice about securities to others. Under this Act, an investment adviser with fewer than 15 clients that does not publicize itself generally as an investment adviser is not required to register with the Commission. Because Commission regulations permit an adviser to count each hedge fund, rather than each investor in the hedge fund, as one client, some hedge fund managers may not be required to register with the Commission.[3] Unregistered advisers are not directly subject to the Commission's examination and inspection program. But, it is important to

[3] We understand that some hedge fund managers voluntarily register with the Commission because some investors, particularly many foreign investors, prefer their managers to be registered. Others register because they also advise registered investment companies, which are required to be advised only by registered investment advisers.

note that all hedge fund managers -- whether registered as investment advisers or not -- are subject to the antifraud provisions of the Investment Advisers Act.

One issue that was raised at a number of the panels at the Roundtable was the SEC's lack of examination and inspection authority over hedge funds, due to the fact that hedge funds typically are not registered with the Commission, and many of their managers are unregistered as well. Some of our panelists argued that if the SEC staff were able regularly to examine hedge fund managers, not only would incidents of fraud potentially decrease, but investors would have more information upon which to make their investment decision. However, other panelists noted that there is cost to any additional registration and examination of hedge fund managers and cautioned the Commission to consider a cost/benefit analysis of the registration of hedge fund managers. With respect to the registration of hedge fund managers as investment advisers, there seemed to be general consensus that the industry is moving in that direction because of market forces—some investors, particularly certain institutional investors, demand that a manager be registered as an investment adviser before investing money in that manager's hedge fund.

Exception from Reporting Requirements under the Securities Exchange Act of 1934. Hedge funds generally are not subject to the periodic reporting requirements of the Securities Exchange Act because they are operated so as not to trigger registration of their securities under that statute. However, if a hedge fund holds large public equity positions, the manager, like any other large institutional manager, must publicly disclose those positions. This disclosure, however, does not necessarily provide significant insight into any particular hedge fund's portfolios or strategies because the manager is permitted to aggregate all clients' holdings into one report. In addition, there may not be comparable disclosure required of short and debt positions.

For long positions, hedge funds have the same disclosure requirements as other market participants. Sections 13(d) and 13(g) of the Exchange Act require the reporting of information with respect to long positions relevant to corporate control and its transfer. Generally, any person who, directly or indirectly, acquires beneficial ownership of more than 5% of a class of equity security registered pursuant to Section 12 of the Exchange Act is required to report such acquisition. In addition, Section 13(f) requires institutional investment managers, including hedge fund managers, who exercise investment discretion over $100,000,000 or more of

equity securities registered under Section 12 to disclose their securities positions on a quarterly basis.

Similarly, hedge funds are subject to the same disclosure obligations as other market participants with regards to short sales. While the Commission's rules generally do not require the disclosure of most short sales or short security positions, rules of self-regulatory organizations require their members to report once a month aggregate short positions in exchange-listed and Nasdaq securities to all customer (including hedge fund customers) and proprietary accounts. This information is publicly available.

The more general issue of short sale and short position disclosure has been raised in the past. In the late 1980s and early 1990s, there were discussions on whether there should be comparable disclosure of short positions in equity securities as there are for long positions. The Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Affairs held hearings on the market role of short selling.[4] Further, a bill was introduced in 1990 that, among other things, proposed requiring the public reporting of material short security positions. Congress did not take any action on the bill.

---

[4] See Short Selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation, Hearings Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Affairs, 101st Cong., 1st Sess. 192 (1989).

In addition, the Commission published a concept release in 1991 soliciting public comment on whether the Commission should require public reporting of material short security positions in publicly traded companies in a manner analogous to the reporting requirements for material long security positions.[5] Subsequently, the Commission did not propose or adopt such proposals, in part, because Commission staff reasoned that:

- It could be unlikely that a reporting requirement would reach any significant portion of the alleged short sale abuses, because a short seller rarely sells as much as 5% of an issuer's outstanding stock. A lower threshold would impose substantial costs, and it could be difficult to justify a lower threshold for short positions than long positions.

- A reporting requirement would not add significantly to the information already available. SROs require members to report short positions in all customer and proprietary accounts and aggregate information, by security, is published monthly. Issuers, through their industry contacts, probably have little difficulty in identifying very large short sellers.

I believe that the current level of disclosure provides investors with some information on both long and short security positions, including hedge fund positions. However, as part of our hedge fund fact-finding investigation, we will consider proposals that would enhance position transparency and increase investor protection in this area.

---

5 See Exchange Act Release No. 29278 (June 7, 1991).

Investor Education Efforts

Before I close, I would like to discuss investor education. Roundtable panelists were nearly unanimous in their call for increased education to alert investors to the risks and rewards of hedge fund trading techniques. The Commission takes its investor education responsibilities very seriously. And in light of the Roundtable comments, we are reviewing possible ways to better educate investors. However, we already have taken several steps.

Since the creation of the Commission's website at www.sec.gov, we have used the website to educate and alert investors to issues relating to securities. Among other things, the website generally discusses hedge funds and funds of hedge funds. We have also used that website to provide investors with important questions that they should ask before investing in these products.

In addition, Commission staff developed a website advertising a simulated hedge fund, Guaranteed Returns Diversified, Inc. ("GRDI" or "greedy", for short). This website demonstrates how easy it is to be taken in by false statements and seeks to sensitize investors to their vulnerability. The Commission's website provides a link to the fake scam, although we've discovered that most are finding it by surfing the Internet looking for quick

and easy returns. Since we launched this website on February 13, 2003, we have had over 80,000 hits on it!

Conclusion

In conclusion, the Commission is far along on its hedge fund fact-finding mission. And we will continue to proceed with a focus on how to best protect investors and our securities markets. I am anxious to take the next step in the process, which is to consider a broad range of issues on the hedge fund industry. I view this as an important next step, as we need to hear from all segments of the hedge fund industry, including those not represented at the Roundtable, as well as those of the investing public. While we had many distinguished, thoughtful and helpful panelists, I am mindful that in such a public forum as a roundtable, we may have heard a guarded version of the state of the industry. It is our duty as the investors' advocate to ensure that we have *all* of the relevant information as we formulate a course of action.

Next, the Commission will have the staff prepare a report outlining its findings from the fact-gathering mission, the Roundtable and public comments. I anticipate the report will address the key issues that have been a focus of our inquiry, including (1) hedge fund trading strategies and market impact, (2) the increasing availability of hedge fund exposure to

retail investors, (3) the disclosures investors receive when investing in hedge funds and on an ongoing basis, (4) the differences between hedge funds and registered investment companies, (5) conflicts of interest, including those created by the fee structures of hedge funds and funds of hedge funds, (6) the role of prime brokers, (7) hedge fund fraud, (8) the regulatory framework applicable to hedge funds, and (9) investor education. I have instructed the staff to include in its report any recommendations for change in the regulatory framework governing hedge funds. I look forward to reviewing this report, analyzing its recommendations and sharing the report with you.

Thank you again for this opportunity to share my insights on the Commission's recent activities relating to hedge funds. I would be happy to answer any questions that you may have.

STATEMENT OF

WASHINGTON LEGAL FOUNDATION

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

of the

COMMITTEE ON FINANCIAL SERVICES OF THE U.S. HOUSE OF REPRESENTATIVES

on

"THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK"

THE RELATIONSHIP BETWEEN SHORT SELLERS AND TRIAL ATTORNEYS

DANIEL J. POPEO
CHAIRMAN AND GENERAL COUNSEL

PAUL D. KAMENAR
SENIOR EXECUTIVE COUNSEL

WASHINGTON LEGAL FOUNDATION
2009 MASSACHUSETTS AVE., N.W.
WASHINGTON, D.C. 20036
www.wlf.org

MAY 22, 2003

Mr. Chairman and Members of the Committee:

The Washington Legal Foundation (WLF) would like to thank the committee for the invitation to submit this written statement for the record on an important issue that has not been addressed by the Securities and Exchange Commission (SEC) or, heretofore, by the Congress: the relationship between trial attorneys and short sellers.

As we will explain in greater detail, evidence suggests that trial attorneys who file class action lawsuits may be selectively providing short sellers and others with information as to when the lawsuit against a publicly traded company will be filed with the court. The stock in the company is sold short before the suit is filed, and profits are realized when the price of the stock falls after the suit is filed and made public. Other questionable devices have been used by trial attorneys, such as encouraging analysts to downgrade the stock of a targeted company to spur the company to quickly settle the underlying suit, regardless of its merits.

WLF believes that this issue has been overlooked or ignored in the post-Enron regulatory, enforcement, and legislative environment designed to restore investor confidence and integrity in the securities markets. Last week, the SEC held a Hedge Fund Roundtable over a two-day period addressing a variety of topics regarding hedge funds, short selling, and related matters; unfortunately, the issue of the relationship between short sellers and trial attorneys was not addressed, despite WLF's request to the SEC that it do so.

Accordingly, WLF applauds the efforts and interest of the committee and its staff to learn more about this aspect of abusive trading practices as part of the overall concern of hedge fund operations and regulation. WLF also encourages the committee to exercise its oversight function by making sure that the SEC addresses this matter as well.

Interests of WLF

WLF is a nonprofit, public interest law and policy center based in Washington, D.C., with supporters nationwide. Since its founding 25 years ago, WLF has advocated free-enterprise principles, responsible government, property rights, a strong national security and defense, and a balanced civil and criminal justice system, all through WLF's Litigation Department, Legal Studies Division, and Civic Communications Program.

Earlier this year, WLF launched its INVESTOR PROTECTION PROGRAM (IPP). The goals of WLF's IPP are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive litigation practices; to encourage congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures.

As part of WLF's IPP, we filed a complaint with the SEC on January 21, 2003 calling on the Commission to conduct to formal investigation into the short-selling of J.C. Penney Co. stock that occurred shortly before and after a major class action lawsuit was filed

against Eckerd Drug Stores which is owned by J.C. Penney. As more fully described in that complaint, serious questions were raised about the selective disclosure of the timing of the lawsuit to short-sellers of J.C. Penney Co. stock as reported in a *Wall Street Journal* article of January 7, 2003, "*Suit Batters Penney Shares, But Serves Short-Sellers Well*," by David Armstrong and Ann Zimmerman. The U.S. Chamber of Commerce's Institute for Legal Reform supported WLF's complaint and urged the Commission to issue a "formal order of investigation." A copy of WLF's complaint is available on our website at *www.wlf.org*. The *Wall Street Journal* article describing the J.C. Penney lawsuit is attached hereto.

On March 24, 2003, WLF filed a Petition for Rulemaking (SEC File No. 4-477) requesting that the SEC require that prior notice be given to the public of upcoming communications between plaintiff's attorneys and analysts, hedge fund managers, short-sellers, and others in order to protect investors in companies that are being targeted for litigation from any subsequent sudden drop in the stock prices of the targeted companies. An example of this kind of contact between trial lawyers and analysts was described by reporter David Segal in his article, *Tag-Team Lawyers Make Business Blink: HMOs Latest to Grapple With Threat of Investor-Scaring Mega-Verdicts*, Wash. Post, Nov. 12, 1999 at A1, an online version of which is attached hereto. WLF's proposal is a variation of the SEC Rule FD (Fair Disclosure) which now requires company officials to make public certain discussions with analysts. WLF's rulemaking petition is also available on our website.

On April 30, 2003, WLF also filed comments with the SEC in response to request for public comments on the two-day Hedge Fund Roundtable that occurred last week. In those comments, WLF requested that the SEC's investigation of hedge funds include the issue of the relationship between plaintiffs' attorneys and short sellers. Those comments are also available on WLF's website.

In recent years, WLF has also opposed proposed class action settlements on behalf of class members objecting to excessive plaintiffs' attorneys fees, while class members receive little if any compensation. *See, e.g.*, *In re Synthroid Mkt. Litig.*, 264 F.3d 712 (7th Cir. 2001); *Wilson v. Massachusetts Mutual Life Ins. Co.*, No. D0101 CV 9802814 (1st Dist., Sante Fe County, NM) (objection filed Feb. 2, 2001); *In re Compact Disc Minimum Advertised Price Antitrust Litigation*, MDL Docket No. 1361 (D. ME) (objections filed March 3, 2003). WLF has also participated in litigation opposing the filing of class action lawsuits against companies simply for failing to meet revenue and profitability projections. *See, e.g.*, *Cypress Semiconductor Corp. v. Yourman*, 2001 Cal. App. Unpub. LEXIS 1963.

WLF's Legal Studies Division has produced and distributed timely publications on securities regulations. WLF's recently published Legal Backgrounders on the topic include: Peter L. Welsh, *Sarbanes-Oxley And The Cost Of Criminalization*; Robert A. McTamaney, *The Sarbanes-Oxley Act Of 2002: Will It Prevent Future "Enrons?"*; and Claudius O. Sokenu, *SEC Expands Foreign Corruption Law Beyond Congressional Intent.*

Finally, as part of WLF's Civic Communications Program, WLF educates the public

by publishing op-eds and similar policy advertisements in the *New York Times, National Journal,* and other major publications. Three recent copies of those publications relating to trial lawyers and Wall Street are attached hereto for the record.

Accordingly, WLF has an long-standing interest in ensuring that lawsuits in general, and class actions in particular, are not prepared, discussed, and filed in such a way so as to cause needless harm to shareholders of the targeted company, or to enrich short-sellers who may have improperly received pre-filing information about the lawsuits.

Short Selling, Trial Attorneys, and SEC Regulation: A Case Example

We recognize that short selling is not inherently antithetical to the interests of investors and the securities markets. Indeed, short selling plays a positive role in the securities market by providing market liquidity and pricing efficiency. But precisely because short selling has an impact on the market, there is also potential for abuse. For example, a "bear raid" occurs when short selling is designed to drive down the price of the stock by creating an imbalance on the sell-side interest. Congress was concerned about so-called "bear raids" following the 1929 stock market crash, and in enacting the Securities and Exchange Act of 1934, Congress gave the SEC the authority to stop short selling abuses.

In response, the SEC has enacted several rules, such as Rule 10a-1 that includes the so-called "uptick" rule which essentially requires that a security may be sold short at a price above the price which the immediately preceding sale was effected. In 1963, the SEC studied short selling in response to a request by Congress, and recommended improvements in short sale data collection, but apparently no action was taken. In 1976, the SEC ordered a general investigation in short selling and considered suspending the uptick rule, but withdrew its proposals due to public opposition.

In 1991, the House Committee on Government Operations issued a report on short selling, agreed that the SEC's uptick rule was valuable as a price stabilizing force, and encouraged Nasdaq to adopt similar restrictions. Moreover, and most relevant for the hearing today, the House Report also concluded that there appeared to be "a pattern of abusive and destructive rumor mongering, targeted specifically at companies in the equity securities of which some short-selling investors have established major short positions."[1] The House Report also recommended that daily and weekly short-selling data activity and interest be obtained from broker-dealers, and be made available electronically. *Id.*

On October 20, 1999, the SEC issued a "concept release" on short selling proposing to eliminate the uptick rule in certain circumstances and to make other changes in regulating short selling. However, no further action has been taken on the subject since then, and it is

---

[1] *Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation* (Part 1) (House Report), H.R. Rep. No. 102-414 (1991).

unclear what the Commission may do in this area in light of the recent Hedge Fund hearings and related ongoing fact-finding by the SEC.

Congress' concern in 1991 about abusive short selling practices was well founded. To be sure, the SEC has taken some enforcement action against a few hedge fund operators and others who have engaged in fraud and illegal market manipulation; but it has failed to address the more subtle and covert relationship between trial attorneys and short sellers that involve the selective release of nonpublic material information regarding class actions or other major lawsuits by trial attorneys with short sellers or analysts.

The following case study involving a class action lawsuit against Eckerd Drug Stores and short selling of J.C. Penney Co. stock, the parent of Eckerd, illustrates what we perceive to be a problem that undermines the integrity of the securities markets and investor confidence. The January 7, 2003 *Wall Street Journal* article referred to earlier described the Eckerd Drug case as "a window into the subculture of short sellers and class-action law firms where negative reports about companies are often seized upon and circulated, to the detriment of the companies and their stocks." *Journal* at 2. In this case, the price of Penney's stock dropped approximately 32 percent from mid-November 2001 to April 2002 when an amended complaint against Eckerd Drugs was filed. Concomitantly, short-selling of the stock rose 43 percent in the 30-day period between January 15 and February 15, 2002.

The *Journal* article raises some very serious and troubling questions about the dissemination of information regarding the timing of the filing of a potentially damaging multimillion dollar class action lawsuit against a publicly traded company, and the ensuing short-selling in the stock of the targeted company. As an initial matter, it is worth noting that the original lead plaintiff, Shirley Minsky, a 77-year old widow from Fort Lauderdale, Florida, was upset to learn from the news that she was the lead plaintiff in the suit; she angrily denied ever talking with any attorney about the suit, much less authorizing the filing of the lawsuit. According to Mrs. Minsky, the attorneys "made up the whole damn story." The lawyers scrambled to find another lead plaintiff who was substituted for Mrs. Minksy. *Gerald Mann v. Eckerd Corp.*, Docket No. 02-02311CACE(18) (Cir. Ct., 17th Jud. Dist., Broward County) (motion to dismiss third amended complaint to be heard June 26, 2003).

More troubling is the sequence of events and communications that led up to the filing of the suit. According to the *Journal* article, Don Reilly, an Eckerd pharmacist, had complained since 2000 to federal and state authorities that he believed Eckerd was overcharging for its drugs. *See Journal* at 2. He was contacted by Terrence Warzecha, an analyst who works for Rocker Partners, a New York hedge fund, who asked Mr. Reilly to talk to Eric Camil, a private investigator known to work with law firms that file class-action securities litigation. While it is not clear from the article whether Mr. Reilly spoke to the investigator, there is no doubt Mr. Reilly was repeatedly contacted by a Clifford Murray, a doctor-turned-analyst with the Boca Raton office of KSH Investment Group, Inc., (KSH), a broker-dealer based in Great Neck, New York. *Id.*

According to Mr. Reilly, Dr. Murray contacted him some "30 to 40 times" to update Mr. Reilly on the timing of the filing of the class action suit against Eckerd. *Journal* at 3. According to Mr. Reilly, Dr. Murray was "communicating with the lead plaintiffs' lawyer in the Eckerd suit before it was filed." Dr. Murray's office denies that he had advance knowledge of the suit, and claims that he "didn't talk to the lead lawyer until after the suit's filing." *Id.* The SEC needs to find out the truth of this assertion.

The lead lawyer was Paul Paradis of the New York class-action law firm of Abbey Gardy, LLP. According to the *Journal*, Mr. Paradis "didn't reply to questions about what prompted his interest in the Eckerd case or whether he discussed a possible lawsuit with short-sellers or other investment pros before filing it." *Journal* at 3. The SEC needs to ask Mr. Paradis these same questions.

The lawsuit was date-stamped at 3:59 p.m. on Friday, February 1, 2002, which is just one minute before the close of the market for the week. Jeff Sultan, the head of the local KSH, told the *Journal* reporter that his aide waited "a good part of the day" at the courthouse to get a copy of the suit, suggesting that he had pre-filing information that the suit would be filed that day. But he later said he was mistaken, claiming that he sent a messenger to get the filing on the following Monday morning. Mr. Sultan claims that neither Dr. Murray nor KSH sold Penney's stock short. But when "[a]sked why, in that case, Dr. Murray spent so much time talking to the pharmacist [Mr. Reilly], and whether the broker-dealer had been advising clients to short the stock, Mr. Sultan didn't respond." *Id.* The SEC needs to find out the answer to that question.

The *Journal* article also quoted David Rocker as stating that his fund opened "its sole short position in Penney shares on the day the suit was filed, adding to it in the following weeks." When asked by the *Journal* reporter if he had advanced knowledge that the suit was going to be filed or if he opened the short position prior to 3:59 p.m. when the suit was actually filed, Mr. Rocker was reported as saying, "I honestly don't know." The SEC needs to get an answer to that question.

In March 2002, a month after the original lawsuit was filed, the *Journal* further reported that Dr. Murray called the Eckerd pharmacist "to say he needed the documents [regarding possible overcharging] quickly." Those Eckerd documents subsequently showed up as exhibits to the first amended complaint filed in April 2002. If this is true, it suggests that Dr. Murray was indeed in contact with the plaintiffs' lawyers in the case.

By the time the amended suit was filed in April 2002, J.C. Penney stock dropped further, totaling 32 percent since mid-November 2001. In addition, short-selling activity in the stock rose 43 percent between January 15 and February 15, 2002. A subsequent investigation by the Florida Attorney General's office concluded that Eckerd did not overcharge for its drugs.

Based on this report, WLF filed a complaint with the SEC on January 21, 2003,

requesting that the SEC investigate the matter and to bring appropriate enforcement action. If no SEC violations occurred, WLF also asked the SEC to inform us and the public of this result, in order to determine whether additional SEC regulations may need to be promulgated or additional legislation enacted to prevent such activity. The SEC acknowledged the receipt of our complaint by sending us a form letter that indicated that unless a public enforcement action were filed, we may never know what the SEC has done with our complaint. For all we know, the SEC may have closed the file in the case or is just letting it sit there without any active investigation. We did forward a copy our complaint to the Department of Justice which has recently informed us that it has turned the material over to the Federal Bureau of Investigation as part of the Corporate Fraud Task Force.

The important question that we have raised by the filing of our complaint is whether the selective disclosure of the timing of the filing of a lawsuit violates any SEC law or regulation. Some have suggested that since there were no falsehoods or misrepresentations about the timing of the lawsuit, there was no fraud or improper market manipulation. We want to emphasize that we do not know whether any of the conduct described in the *Journal* article violated any SEC law or regulation. However, we would think that at a minimum, factual information, including trading, telephone, and computer records, should be obtained and examined. For all we know, an investigation may reveal that short sellers or their agents provide class action attorneys with potential damaging information about a company with the understanding that if the attorneys decide to use that information as a basis for a lawsuit, the short sellers will get a "heads up" as to when the suit will be filed.

One SEC regulation that should be relevant to any inquiry into this kind of relationship between plaintiff's attorneys and short sellers is Rule 10b-5 (17 C.F.R. § 240.10b-5). Rule 10b-5 generally prohibits traditional or classical "insider" trading as well as "misappropriation" of material information that is confidential and nonpublic. *See generally United States v. O'Hagan*, 521 U.S. 642 (1997). SEC Rules 10b5-1 and 10b5-2, promulgated in 2000 also may be relevant.

As one court described it, the "[m]isappropriation theory is targeted at 'outsider' trading, i.e., breaches that do not involve a duty to the traded company and its shareholders." *United States v. Kim*, 184 F. Supp. 2d 1006, 1012 (N.D. Cal. 2002). Thus, in a classical insider trading case, an insider with material nonpublic information about the company has either traded on the information, or has tipped a friend or outsider with the information who has traded on the information. However, if someone not affiliated with the company nevertheless possesses material nonpublic information about the company, breaches a duty of trust or confidence, and trades on that information or allows others to do so, a case could be made under *O'Hagan* for insider trading.[2]

[2] For an excellent discussion of the judicial development of the *O'Hagan* "misappropriation" theory by the Supreme Court and lower courts, see A.C. Pritchard, United States v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider*

There can be no doubt, however, that attorneys have a fiduciary relationship with their clients, including those in a class action case. The attorney is an agent of his or her client who is the principal. There can also be no doubt that the filing of a multimillion dollar class action lawsuit adversely affects the price of the stock of the targeted company. Consequently, the timing of the filing of such a suit is material nonpublic information that is confidential between the lawyer and the client. Until the suit is filed, the client is free to discharge his or her attorney, or to decide not to file the suit at the last minute. The bottom line is that an attorney is not permitted to divulge filing information with short sellers without the express permission of the client.

Selectively sharing pre-filing information about the suit, and the timing of its filing, can be extremely valuable to those who engage in short-selling. As reported, allegations of overcharging had been circulated by Mr. Reilly for quite some time before the suit was filed without any significant damage to the value of J.C. Penney's stock. But the actual filing of the suit, an act almost totally within the control of the plaintiff's attorney, is itself the "bad news" that affects the price of the stock, over and above the merits of the underlying allegations. Attorneys who have practiced in this area have told us that the J.C. Penney case is not an isolated case. But only the SEC can determine the full extent of the practice, and only the SEC can take the necessary steps to prevent this kind of short-selling from taking place. The committee should demand that the SEC do so or explain to the committee why it will not undertake the necessary measures to curb this kind of short selling activity.

In addition to this kind of relationship between trial lawyers and short sellers, we would also like to bring to the committee's attention yet another tactic that has the effect of downgrading the value of a company's stock. For example, in late September 1999, the share value of national Health Maintenance Organizations (HMOs) lost over $12 *billion* in stock value in a single day following news of class action lawsuits by a consortium of plaintiffs' lawyers against the companies. *See* David Segal, *Tag-Team Lawyers Make Business Blink: HMOs Latest to Grapple With Threat of Investor-Scaring Mega-Verdicts*, Wash. Post, Nov. 12, 1999 at A1. According to the Segal article, "By leveraging the might of the stock market, these legal collectives [of plaintiffs' lawyers] are altering the balance of power in the never-ending battles between trial lawyers and the companies they sue." *Id.* at 1.

Professor George Priest of Yale Law School summarized the power that the filing of these suits have on a company's share price when he stated, "It's the fear of the nuclear-bomb verdict that gives leverage to plaintiffs' lawyers to make threats and play off a company's stock price. . . . Jury verdicts nowadays can put companies out of business." *Id.* The Segal article also noted another method used by trial lawyers to use Wall Street to depress the price of the stock of a targeted company.

Trading, 78 B.U.L.Rev. 13 (1998).

> In the HMO suits, Wall Street is playing its most prominent role to date. One lawyer. . . Richard Scruggs of Mississippi, has taken the unusual step of meeting with key HMO analysts at Morgan Stanley Dean Witter and Prudential Securities and even participated in a conference call with dozens of institutional investors.

Id. at 2. According to the article, Scruggs was quoted as saying, "If HMO investors are smart, they'll lean on their companies to see if we can work something out [to settle the class action lawsuits]. *Id.* at 4. Some industry targets view these tactics to force settlements with alarm. According to Aetna's chief executive Richard L. Huber, "In one day, more than $10 billion in American savings was vaporized just by the bark of the wolf. The brazenness is astounding." *Id.* at 2.

Clearly these discussions with analysts and institutional investors can have, and do have, a significant impact on the price of the stock of the targeted company or industry. Just as clearly, it would be in the public interest for the entire investment community, including the targeted company, to be notified ahead of time of these communications and be afforded an opportunity to participate in these heretofore one-sided and biased communications. Consequently, as noted, WLF filed a Petition for Rulemaking with the SEC on March 24, 2003, to devise a disclosure rule that would require trial attorneys to give pre-notification to the SEC and the public of discussions with analysts, short sellers, and others about potential or pending lawsuits. The petition is pending before the SEC.

Conclusion

WLF appreciates the opportunity to present its views on this important topic to the committee. We look forward to working with the committee and its staff, as well as with the SEC and other regulatory and enforcement entities or agencies, to restore investor confidence and integrity in the securities markets by curbing abusive trading practices fostered by trial lawyers.

Thank you.

Daniel J. Popeo
Chairman and General Counsel

Paul D. Kamenar
Senior Executive Counsel

Washington Legal Foundation
2009 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 588-0302
www.wlf.org

Date: May 22, 2003

THE WALL STREET JOURNAL.

Article 1 of 6

Sowing Doubt:
Battering Penney,
A Lawsuit Served
Short-Sellers Well

Investors Helped to Pursue
Claim That Eckerd Unit
Had Overbilled for Drugs

In Search of a Lead Plaintiff
By David Armstrong and Ann Zimmerman

01/07/2003
The Wall Street Journal
Page A1

Shirley **Minsky** was observing the seven-day Jewish mourning period for her husband last January when a family friend called not to offer his condolences, but to get information. He wanted to know if she used a prescription eyedrop called Xalatan.

Mrs. **Minsky** , a 77-year-old in Fort Lauderdale, Fla., says she was too upset to talk to the caller. She says the caller did speak to her daughter, though, and told her the pharmacy might have been overcharging for Xalatan. He asked for some information from her prescription label, Mrs. **Minsky** says.

A week later, a civil lawsuit accused Eckerd Drug Stores of widespread overcharging for prescription drugs. On behalf of Eckerd customers, the suit demanded $100 million in damages. It had one named plaintiff: Mrs. **Minsky** .

She says she never talked to any of the lawyers who filed the litigation. In fact, she didn't even hear about the suit, Mrs. **Minsky** says, until a neighbor read about it in a newspaper and told her.

"They made up the whole damn story," Mrs. **Minsky** says of the plaintiffs' lawyers. "I am ashamed to go back to Eckerd's . . . . What kind of person would do this to me? It's awful."

Four law firms that filed the suit declined requests to discuss it,

although one lawyer, Paul Paradis, contends he did have Mrs. **Minsky** 's authorization to sue Eckerd on her behalf.

The suit -- with a new plaintiff inserted after Mrs. **Minsky** complained -- has made little progress since it was filed 11 months ago. The Florida attorney general closed an investigation sparked by the suit, after finding no evidence Eckerd had overcharged. The lawsuit, however, had one distinct effect: It knocked down the shares of J.C. Penney Co., owner of the Eckerd chain. Painful for shareholders, this drop rewarded another group of investors -- short-sellers, the people who bet on stock declines.

Short-sellers naturally take an interest in and investigate any reports that might cause a stock to fall. Sometimes they go further. The Eckerd case offers a window into a subculture of short-sellers and class-action law firms where negative reports about companies are often seized upon and circulated, to the detriment of the companies or their stocks. Among the players in this case was Martin Lacoff, a consultant to class-action law firms and the family friend who called Mrs. **Minsky** .

The shorts' story begins in November 2001, when an investment analyst heard a tip that an Eckerd pharmacist in Deltona, Fla., was saying he had evidence of fraud by his employer. The analyst, Terrence Warzecha, works for Rocker Partners, a New York hedge fund, or private investment pool, that is known for often taking short positions. Mr. Warzecha says he began calling Eckerd drugstores in the Deltona area.

At one store, druggist Donald Reilly answered the phone. "Are you the whistleblower?" Mr. Warzecha asked.

For several years, in fact, Mr. Reilly had been voicing suspicion that Eckerd was overcharging customers who received certain quantities of liquid and cream prescriptions. He based this on his reading of drug labels and computer screens, which seemed to show Eckerd getting paid for more medicine than it dispensed. In 2000, Mr. Reilly wrote to the Food and Drug Administration, which referred the complaint to the Florida Board of Pharmacy. He also faxed documents to state and federal Medicaid investigators and to the state insurance-fraud bureau, all without apparent result. Mr. Reilly says he has never sold Penney's shares short.

When Mr. Warzecha of Rocker Partners called, Mr. Reilly says he eagerly shared documents copied from an Eckerd store. The analyst "seemed to be very excited," Mr. Reilly says. "He would say this is going to kill them. This will be very detrimental. This will cost them money."

Mr. Warzecha says he can't recall specifics of his talks with Mr. Reilly but says he believed the pharmacist had uncovered massive

fraud. "Don was morally outraged as to what he saw or found and when he conveyed to me the information, I was likewise morally outraged," Mr. Warzecha says.

The Rocker Partners analyst, asked if he had a role in unearthing allegations later made in the lawsuit against Eckerd's corporate owner, says, "I did a lot of the initial work. We were interested in it as short-sellers and how big the fraud was and would it have a meaningful impact." (Short-sellers borrow shares and sell them, hoping to replace them later after their price has fallen.)

As early as November 2001, some investors who follow Penney began hearing rumors of a possible lawsuit or government action against its drugstore division. Penney's share price began to slide in the middle of that month.

In December 2001, Mr. Reilly says, Mr. Warzecha asked him to talk to Eric Camil, a private investigator known by hedge-fund managers for his work with law firms that file class-action securities litigation. Mr. Warzecha says Rocker Partners didn't pay Mr. Camil.

Eckerd, the country's fourth-largest pharmacy chain, was an enticing potential target for short-sellers. It had just agreed in mid-2001 to pay $1.2 million to resolve a 1996 federal criminal investigation for allegedly billing Medicaid full amounts on prescriptions only partly filled. Eckerd neither admitted nor denied those charges.

Penney Chairman Alan Questrom says he heard the overcharging rumors in December 2001 from a banker who cited Rocker Partners as his source.

By January 2002, says Mr. Reilly at Eckerd, his home phone number was widely known among short-sellers. The pharmacist says an especially frequent caller was Clifford Murray, a doctor-turned-analyst at the Boca Raton office of KSH Investment Group Inc., a broker-dealer based in Great Neck, N.Y.

The pharmacist says Dr. Murray called 30 to 40 times, sometimes updating Mr. Reilly on the progress toward filing the suit and what the timing might be. Mr. Reilly adds that Dr. Murray frequently admonished him never to reveal their conversations. After a reporter contacted Dr. Murray recently, the doctor left a message on Mr. Reilly's answering machine saying, "I don't know what you have done or said. . . . I don't want this to turn ugly."

The head of KSH's Boca Raton office, Jeff Sultan, says Dr. Murray "does not recall" leaving such a message.

The pharmacist says Dr. Murray indicated he was communicating with the lead plaintiffs' lawyer in the Eckerd suit before it was filed. Mr. Sultan responds that the analyst didn't have advance knowledge

of the suit and didn't talk to the lead lawyer until after the suit's filing.

That lead lawyer was Mr. Paradis, who is with a New York class-action law firm called Abbey Gardy LLP. Mr. Paradis didn't reply to questions about what prompted his interest in the Eckerd case or whether he discussed a possible lawsuit with short-sellers or other investment pros before filing it.

The suit was filed at 3:59 p.m. on Friday, Feb. 1, a clerk's stamp at the Fort Lauderdale courthouse shows. Mr. Sultan of KSH says he had sent an aide to the courthouse to pick up a copy on the day of the filing. The aide had to wait "a good part of the day" for it to be filed, he says, and "it was after 4 p.m. that he got his hands on a copy of the suit."

Mr. Sultan says KSH didn't have any advance knowledge of the suit. Asked why he sent an aide for a copy of it hours ahead of time, Mr. Sultan said he believed there had been a news report indicating it would be filed. If there was such a report, Eckerd says it didn't know about it. Later, Mr. Sultan said he had been mistaken and actually didn't send a messenger until the Monday after the filing. He produced a courthouse receipt for lawsuit photocopies obtained the following Monday.

Mr. Sultan said neither Dr. Murray nor KSH was ever short Penney's shares. Asked why, in that case, Dr. Murray spent so much time talking to the pharmacist, and whether the broker-dealer had been advising clients to short the stock, Mr. Sultan didn't respond.

A week before the suit's filing, on a day when Penney's stock was down, public television's "Nightly Business Report" said a Penney spokesman mentioned an "unconfirmed rumor" that Eckerd had overcharged Medicaid. Penney issued a formal denial of the rumor the next day. By that time, its stock was down about 15% from the price when the rumors began two months earlier. Short-sellers' activity in the stock rose 43% between Jan. 15 and Feb. 15, New York Stock Exchange data show.

Penney's shares fell further in the week following the filing of the suit on Feb. 1. They took another hit in April when plaintiffs' lawyers amended the suit, raising the damage estimate to "at least several hundred million dollars." The amended suit added three dozen more drugs for which it said Eckerd had overbilled.

Mr. Reilly says he provided documents for exhibits about those drugs in the amended complaint. The pharmacist says he did this at the request of KSH's Dr. Murray, who, the pharmacist says, called in March to say he needed the documents quickly.

By then, Penney shares had fallen 32% from the mid-November pre-

rumor price. Stocks in general were rising at the time, and sales and profitability were improving at both Penney and its Eckerd unit, which is the source of 40% of Penney's revenue. "The rumors of litigation and the suit brought the stock down drastically," says Dan Barry, a Merrill Lynch retail analyst who follows Penney.

At Rocker Partners, founder David Rocker says the fund opened its sole short position in Penney shares on the day the suit was filed, adding to it in the following weeks. Asked if he knew the suit was going to be filed on that day or if he opened the short position prior to the 3:59 p.m. filing of the suit, Mr. Rocker says, "I honestly don't know."

Mr. Rocker says he gradually closed out the short position, eliminating it in May. He won't say how big the position was or how the hedge fund did on it.

He says there was no organized effort to drive down Penney shares. "You may have thought this was done with shorts talking to each other and creating a story, and I want to disabuse you of this notion," Mr. Rocker says. "People talk, but it is no different than what happens on the long side" -- that is, among those who bet on shares to rise.

Mrs. **Minsky** , the woman the suit listed as plaintiff, says she had never spoken to Mr. Paradis or any of the other plaintiffs' lawyers involved. Mr. Paradis, while declining to answer several questions about the case, said, "We clearly had Mrs. **Minsky** 's consent and authorization to represent her and file a lawsuit against Eckerd."

Mr. Lacoff, the family friend who called to learn whether Mrs. **Minsky** used eyedrops sold by Eckerd, lives in Boca Raton. A mansion he owns in Greenwich, Conn., was rented to Martin Frankel, the reclusive financier who looted small Southern insurance companies, fled and was nabbed in Germany. Mr. Lacoff's Capital Markets Legal Consulting Inc. helps identify targets for firms that file class-action lawsuits.

His wife, Cheryl Rona Lacoff, has been a plaintiff in two such suits, including one against the publishers of "The Beardstown Ladies' Common-Sense Investment Guide," a suit that said the book misstated the ladies' investment return. The suit was her husband's idea, according to plaintiffs' lawyer Oliver Koppell.

Mr. Koppell, a former New York state attorney general, says he pays Mr. Lacoff a monthly consulting fee to come up with case ideas. "He is very inventive and creative," Mr. Koppell says. "He has brought me many ideas. Sometimes friends are involved. Sometimes he comes up with an idea with a plaintiff." Mr. Koppell and Ms. Lacoff lost their Beardstown Ladies suit in New York but joined up with lawyers who were pursuing a similar action in California. In that

state, the lawyers eventually agreed to a settlement. Buyers of the book got another book free from the publisher, while several law firms shared a $1.4 million fee.

The Eckerd lawsuit, filed in Broward County, Fla., Circuit Court, alleged that Mrs. **Minsky** 's Xalatan package contained 2.5 milliliters of the eyedrops, but that the label said 3 milliliters. Eckerd had "rounded up" the amount and charged her and others for too much medicine, the suit asserted.

The practice of rounding up label amounts dates from the 1970s, when it was instituted to save computer memory by eliminating decimal points. Most major drugstore chains did it, but all say they charged the correct price, and some later stopped the rounding-up. Eckerd began phasing out the practice in 2001, before the suit was filed.

Eckerd says that while the amount on the label for liquids and ointments was often inaccurate, owing to rounding-up, its computers were programmed to charge the correct price.

Florida's attorney general, after investigating, concluded in July that it would have been difficult for Eckerd to overcharge private health insurers or Medicaid. That's because liquids and ointments are packaged in certain sizes, and the bill payers will pay only a predetermined, fixed price for these sizes. If an incorrect price is put into their payments systems, computers reject the claim. "The billing process for third parties makes it very difficult to overcharge on fractional quantities," says John Newton, Florida's senior assistant attorney general. His office also concluded it was highly unlikely Eckerd had overcharged uninsured customers who pay their own bills.

AdvancePCS, the largest pharmacy-benefits manager, said after the suit was filed that if a drugstore chain tried to submit an inflated claim, AdvancePCS's computers would catch the incorrect price and reject it.

The lawsuit against Eckerd still is pending. The case frustrates Penney's Mr. Questrom, who says that because of it, "We lost credibility with our customers, our shareholders lost a lot of money, and our pharmacists were shamed."

Mr. Reilly, the pharmacist, says he remains convinced his employer overcharged customers, but he acknowledges that the evidence he gathered isn't definitive. Mr. Reilly says Eckerd suspended him in March, with pay, accusing him of removing company documents. He says the short-sellers no longer call.

(END OF STORY)

Return to Headlines

Tag-Team Lawyers Make Businesses Blink

HMOs Latest to Grapple With Threat of Investor-Scaring Mega-Verdicts

David Segal Washington Post Staff Writer
November 12, 1999; Page A1

NEW ORLEANS -- Without even setting foot in a courtroom, Russ and Maury Herman have frightened a fortune out of the health insurance industry. The brothers and law partners have created a "national mega-firm," linking lawyers across the country to sue **HMOs** for a variety of alleged frauds. It's unclear whether these cases will win over judges or juries. But spooked by litigation filed by the Hermans and others, investors unloaded shares of national **HMOs** in a late-September frenzy, erasing $12 billion in stock value in a single day. Some of the companies have yet to recover.

"What the **HMOs** need is an attitude adjustment," drawls Russ Herman, the older of the pair. The sell-off highlighted a new style of legal attack that has helped plaintiffs' lawyers win record-setting sums in the past year. Once loners by nature, trial lawyers are now allying to split costs, share information and demonstrate that their pockets are deep enough for protracted war.

The strategy is giving corporate America a gang problem of its own. The key audience in these campaigns isn't the targeted companies, whose coffers still dwarf the combined bank accounts of even the wealthiest plaintiffs' firms. It is Wall Street, which in some notable cases has severely battered the share prices of corporate defendants, pushing them to the settlement table.

By leveraging the might of the stock market, these legal collectives are altering the balance of power in the never-ending battles between trial lawyers and the companies they sue.

Juries are increasingly willing to punish businesses with huge punitive-damages verdicts, angling to send messages to other players in an industry. In 1998, the top 10 verdicts awarded in the United States totaled $2.8 billion, up 375 percent over the top 10 verdicts of 1997, according to Lawyers Weekly USA. Those figures have turned courts into increasingly treacherous and unpredictable terrain for corporations.

"It's the fear of the nuclear-bomb verdict that gives leverage to plaintiffs' lawyers to make threats and play off a company's stock price," said George Priest, a professor at Yale Law School. "Jury verdicts nowadays can put companies out of business."

At the same time, a handful of judges, frustrated with the paralysis of legislatures, have been allowing plaintiffs' lawyers to try out legal theories once considered adventurous

at best. The New York lawsuit that helped breathed life into what is now a multi-city assault on the gun industry, for instance, was based on a concept that other judges have rejected for years.

Some corporate lawyers now say that the legal merits of any given case are all but beside the point. What matters most is putting together a squad of lawyers big and rich enough to convince Wall Street that a company will be bogged down in courts for years.

"It's legal extortion," said Victor Schwartz, counsel to the American Tort Reform Association, a group that has lobbied for tighter limits on class-action suits. "Every CEO fears the random billion-dollar verdict and the wrath of stockholders that could bring. But when companies settle, even if it isn't on the merits, the stock will rise."

Consumer advocates and some academics contend that plaintiffs' lawyers are merely leveling a battleground that has long been tilted disastrously against them. Fortune 500 companies, they say, have for years tried to overwhelm adversaries through attrition, swamping their far smaller antagonists with reams of documents and stalling long enough to force them to the brink of bankruptcy.

"If your opponent has tremendous financial resources, you need tremendous financial resources," said Heidi Li Feldman of Georgetown University Law Center. "Until the early 1990s, the plaintiffs' bar didn't have the financial resources to compete."

Tag-team lawyering began in earnest during the tobacco wars of the 1990s and has since been refined by various practitioners. Aided by e-mail messages and CD-ROMs, for instance, an allied scrum of attorneys recently provoked American Home Products Corp. into a $3.75 billion out-of-court settlement with users of the fen-phen diet pill combination. Company executives said their willingness to deal was driven largely by the need to resuscitate the company's shares, which were nearly cut in half by investors fretting over the prospect of years of litigation.

In the **HMO** suits, Wall Street is playing its most prominent role to date. One lawyer who is not affiliated with the Hermans, Richard **Scruggs** of Mississippi, has taken the unusual step of meeting with key **HMO** analysts at Morgan Stanley Dean Witter and Prudential Securities and even participated in a conference call with dozens of institutional investors.

According to **Scruggs**, the purpose of these discussions is to educate. "In the past, nobody has communicated directly with investors about the vulnerability of their money," **Scruggs** explained. "Executives usually get their advice from company lawyers who tell them to fight until the last investor's dollars are spent."

Officials at Aetna Inc., a defendant in one of the suits, have a more sinister take on **Scruggs**'s dialogue with Wall Street, describing it as part of a campaign to frighten **HMOs** to the negotiating table.

"In one day, more than $10 billion in American savings was vaporized just by the bark of the wolf," said Aetna chief executive Richard L. Huber, referring to the plunge taken by **HMO** shares after the lawsuits came to light. "The brazenness is astounding."

Billions in legal fees are spent every year by U.S. corporations defending against a

dizzying variety of product-liability and personal-injury suits. To plaintiffs' lawyers, the suits are an invaluable way to hold corporations accountable for corner-cutting that harms consumers. Critics of the tort system contend these lawyers are far better at enriching themselves than winning justice for clients, who in some case have ended up with trifling sums while their attorneys pocket millions of dollars.

Veterans of dozens of court triumphs, the Hermans are taking joint lawyering to another level. Short, wry and ubiquitous, the brothers have built their practice courtesy of a series of chilling accidents, such as railroad collisions and industrial explosions. One plaque in their office heralds a $3.5 million settlement for an elderly woman who was the victim of an electric shock administered by a hand-held "personal massager."

That award began to seem like chump change after the brothers were hired by Louisiana's attorney general to join a group of lawyers participating in landmark tobacco lawsuit, a case that yielded a $260 billion out-of-court settlement. Two years ago, when the Hermans conceived a full-blown attack on **HMOs**, they concluded that the litigation would be too risky and expensive to go it alone.

"We're not foolish," Russ Herman said with a grin. "We've got families to support."

They decided to launch a "firm of firms," as they call it. Enlisting firms in California, Georgia and Mississippi that had been co-counsels with the Hermans in previous cases, the group commissioned a study to determine where the new firm should be based. Atlanta got the nod because it's an air-transportation hub and home to four law schools, which will make it easier to recruit the teams of researchers the firm needs.

For help drafting a first-of-its-kind partnership agreement, Russ Herman called on the Washington firm of Patton Boggs, run by the Hermans' longtime family friend Tommy Boggs. After months of research and $500,000 in start-up costs, Herman, Middleton, Casey & Kitchens, as the firm is called, opened its doors in July. The Hermans expect that litigating the **HMO** cases could cost a total of $3 million, and perhaps much more.

Since the brothers went public with their plans in late September, other firms have filed similar actions, including a case against Humana Inc. When news of these suits hit Wall Street, shares of Aetna dropped 18 percent and a Morgan Stanley index of health insurance stocks sank by 10 percent. The companies have since regained some, though hardly all, of those losses. Last month, the House of Representatives added to the woes of insurers by voting to broaden the rights of patients to sue their **HMOs**.

While success with these suits is hardly assured, the sheer magnitude of this onslaught, coupled with the enduring unpopularity of the **HMO** industry and the pummeling of insurance companies at the hands of Wall Street, could matter more than the legal niceties. Tobacco companies, after all, settled at a negotiating table rather than duke it out in the courts, where they prevailed for years. Public opinion was turning against cigarette makers, and they finally faced foes with enough cash to last through countless trials. Investors fled in droves.

In its basic outlines, that's the predicament facing managed care today.

"If **HMO** investors were smart," said plaintiffs' lawyer Richard **Scruggs**, "they'll lean on their companies to see if we can work something out."

(END OF STORY)

IN ALL FAIRNESS

Overlooking Stock Manipulation

With American workers and pensioners more concerned than ever about their invested life savings, politicians and media talking heads are still busy deciding who's to blame for Wall Street's doldrums. Regulators are now focused on influential analysts and investment services who they suspect play fast and loose with "hot" financial information to the detriment of unsuspecting investors.

Unfortunately, in the rush to condemn corporate insiders, lawmakers and the Administration have neglected to fully consider and review the actions of some influential *outsiders*. These new players — plaintiffs' lawyers — are heavily invested in the financial market, but they profit by devaluing, not trading, company stocks. They leverage the power of America's unpredictable civil justice system to play the financial media, and Wall Street, like a piano.

Daniel J. Popeo
Chairman
Washington Legal Foundation

Plaintiffs' lawyers excel at using the headlines generated by their mega-lawsuits to inject fear and doubt into the market. Shareholders and executives know that massive damage awards can randomly wreak havoc on stock prices, bond values, company reputations, and ultimately investor confidence. Even the mere threat of a lawsuit can choke off access to already scarce financial capital.

Thus, the new target audience for the plaintiffs' bar and its skillful PR efforts is not judges and juries, but Wall Street itself. Lawsuits that may never be successful in court nonetheless can pose such overwhelming threats to share value that companies are compelled to settle.

Direct pressure on key market insiders can further this lawsuit-induced anxiety. For example, one leading plaintiffs' lawyer met with institutional investors and financial analysts to discuss newly filed lawsuits. He declared to the *Washington Post*, "If investors were smart, they'll lean on their companies to see if we can work something out." Not surprisingly, the collective share value of the defendant companies plummeted $12 billion in a single day.

In their quest for profit, plaintiffs' lawyers have become oblivious to the pain their manipulative tactics inflict on the ordinary Americans they claim to represent.

Wall Street in the bull's-eye

Middle-income families and blue-collar workers were among the victims when negative verdicts sent the stock value of companies as diverse as Dow Corning, ABB, and Georgia Pacific, plummeting by 30% or more last year. Other investors and employees also paid the price recently when cascading class actions instigated a 50% drop in the stocks of one producer of life-saving drugs.

How many nest eggs have to be shattered before the SEC or other corporate crusaders connect the dots between shareholder losses and the litigation lottery, and take action? Perhaps there is also an oversight role here for the ABA. Investors should be guaranteed that no one inside *or* outside Wall Street should reap dividends by gaming the system.

If something isn't done soon, the plaintiffs' bar will turn everyone's stock holdings and retirement plans into their own personal pension fund.

WLF Washington Legal Foundation
Advocate for freedom and justice®

WASHINGTON LEGAL FOUNDATION • 2009 MASSACHUSETTS AVE., NW • WASHINGTON, DC 20036 • http://www.wlf.org

In All Fairness is produced through WLF's Civic Communications Program.

As seen January 2003 in *ARIZONA REPUBLIC, CONGRESS DAILY AM, DENVER BUSINESS JOURNAL, THE DENVER POST, HOUSTON CHRONICLE, THE LOS ANGELES TIMES, MINNEAPOLIS STAR TRIBUNE, NATIONAL JOURNAL, THE NEW YORK TIMES* OP-ED, *OMAHA WORLD HERALD, THE OREGONIAN, ROLL CALL, SALT LAKE TRIBUNE,* AND *THE ST. LOUIS POST-DISPATCH.*

WLF's Civic Communications Program publishes "In All Fairness" in the national edition of the New York Times. The op-ed feature reaches 4.2 million readers in 70 major markets, as well as a diverse group of thought leaders, decision makers, and the public.

THE NEW YORK TIMES **OP-ED** *MONDAY, MARCH 10, 2003*

IN ALL FAIRNESS

An Idiot's Guide to Class Actions

Wall Street and your stock holdings are now at the top of the lawsuit industry's hit list. Here's a page from the Securities Class Action Plaintiffs' Lawyers' playbook:

* Maintain large stable of gullible potential plaintiffs who won't interfere with your case. Remember, it's best not to have a real client.

* Create in-house consulting group to conceive seminars on how to expand opportunitites for plaintiff suits – invite hedge funds, judges and regulators – great forum to exchange "ideas".

* Have minions scour news reports for bad news about any company – use inventory of plaintiffs and a recycled complaint to file suit the next day. Accuse management of greed, lying, fraud, insider trading and suppressing bad news. Don't worry that you have no evidence, you can manufacture that later. Generate plenty of stories in the press.

Daniel J. Popeo
Chairman
Washington Legal Foundation

* Donate to key politicians directly, indirectly and through fronts and PACs to maintain access, stir up unwarranted investigations, generate Congressional hearings, get leaked corporate documents and secrets, circumvent discovery laws and prevent rational legal reform.

* Seek to create general impression with the public that most corporations and business people are out of control, greedy and not to be trusted.

* Drive stock price down further by press releases. Plant negative research reports, rumors and innuendo. The bigger the drop, the more the short sellers make, and, speculative damages get huge. Don't worry that the drop in stock price harms investors, pension funds and 401Ks – that only leads to more plaintiffs and higher losses to support even higher damage claims.

* Cultivate relationships with disgruntled employees to develop leaks, stolen documents and misinformation. Feed negative rumors to the media to continue downward stock price spiral.

* Attempt to blackmail the target company and coerce settlement. Structure it so no one challenges your claim for over 30% in fees. Be sure to make it so complicated that no class member can understand that you get the money, and they get virtually nothing.

* Cash in on asbestos, tobacco, drugs and telecom. Make plans to move on to other target industries like food, recreation, education and transportation.

* Get rich...really rich, while destroying investor confidence in the market.

* Repeat all of the above quickly...before people finally wake up and understand the suckers' game that plaintiffs' lawyers, with some help from the short sellers, are perpetrating on the public...and before the system can be reformed.

WLF Washington Legal Foundation
Advocate for freedom and justice®

WASHINGTON LEGAL FOUNDATION • 2009 MASSACHUSETTS AVE., NW • WASHINGTON, DC 20036 • http://www.wlf.org

In All Fairness is produced through WLF's Civic Communications Program.

Chairman Donaldson,

What are you and the SEC doing to protect investors from plaintiffs' lawyers and short sellers manipulating the market?

Investors, employees, pensioners, and companies lose millions of dollars in stock value each year thanks to abusive class action practices. Driving down those stock prices through behind-the-scenes contacts with Wall Street analysts and short sellers is the newest weapon in plaintiffs' lawyers' arsenal. And it's all being done right under the noses of SEC regulators.

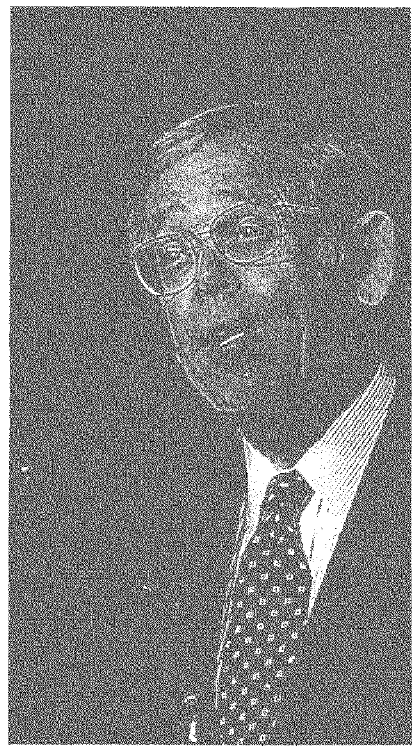
The solution: More rigorous SEC enforcement *and* reforms requiring disclosure of relationships between the plaintiffs' bar and short sellers.

Washington Legal Foundation (WLF), as part of its Investor Protection Program, has filed several formal complaints with the SEC asking it to initiate immediate reform. The U.S. Chamber of Commerce recently joined WLF in calling upon the Commission to investigate recent short-seller/ plantiffs' lawyer manipulation.

Chairman Donaldson, you take every opportunity to tell American investors how SEC is acting to protect their interests. Yet, the Commission is overlooking a very serious, and preventable, manipulation of the market. When will the SEC make an ongoing commitment of resources to investigate the abusive relationship between plaintiffs' lawyers and short sellers?

WLF Washington Legal Foundation
Advocate for freedom and justice®

For more information about WLF's Investor Protection Program, visit WLF's website at **www.wlf.org.**



"The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"
U.S. House of Representatives,
Committee of Financial Services,
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
May 22, 2003

Testimony by Owen A. Lamont
Graduate School of Business, University of Chicago and NBER

Owen Lamont, Graduate School of Business, University of Chicago, 1101 E. 58th St., Chicago IL 60637, phone (773) 702-6414, fax (773) 702-0458. owen.lamont@gsb.uchicago.edu

I am pleased to have this opportunity to testify about the state of the hedge fund industry and the role of short sellers in capital markets.

As an economist, I am concerned with prices. It is important that we get the prices right. When security prices are wrong, resources are wasted and investors are hurt. In order to get prices right, we need to allow all information, both positive and negative, to get into the market. Short selling is one way that negative information gets into the market. Without short selling, stocks can become overpriced because only optimistic opinions are reflected in the stock price.

Our current financial system is not set up to encourage short selling. We have well-developed institutions, such as mutual funds, to encourage individuals to buy stocks, but few institutions to encourage them to short. As events of the past few years have made clear, the infrastructure of our system, such as analysts, underwriters, and some elements of the media, have had an overly optimistic bias. In addition to this optimistic bias, there are technical issues with short selling related to our system of lending equities. Simply put, our system is not designed to facilitate short selling of equities, and it can be difficult or impossible to short some stocks.

Constraints include various costs and risks, such as the expense and difficulty of shorting, legal and institutional restrictions, and the risk that the short position will have to be involuntarily closed due to recall of the stock loan. If these impediments prevent investors from shorting certain stocks, these stocks can be overpriced and thus have low future returns until the overpricing is corrected. The mechanics and institutional details of short sales in US equity markets have changed little in the past century. Unlike the Treasury market and the derivatives markets, the equity shorting market has actually regressed in some respects, a point discussed

further in Jones and Lamont (2002).

To be able to sell a stock short, one must borrow it, and because borrowing shares is not done in a centralized market, finding shares can sometimes be difficult or impossible. In order to borrow, an investor needs to find an institution or individual willing to lend. These lenders receive a daily lending fee from the borrowers, determined by supply and demand in the lending market. Brokers have the ability to lend shares of their customers, provided customers have given written permission. Once a short seller has initiated a position by borrowing stock, the borrowed stock may be recalled at any time by the lender. If the short seller is unable to find another lender, he is forced to close his position. This possibility leads to recall risk, one of many risks that short sellers face.

Generally, it is easy and cheap to borrow most large cap stocks, but it can be difficult to borrow stocks which are small, have low institutional ownership, or which are in high demand for borrowing. A somewhat paradoxical description of the stock lending market is that it usually works very well, except when you want to use it, in which case it works terribly. By this I mean that it can be difficult or expensive to short stocks that many people believe are overpriced and many people want to short. Of course, this point is the essence of the overpricing hypothesis: stocks are only overpriced when informed investors are unable or unwilling to short them. No one would want to short them if they weren't overpriced, and they wouldn't be overpriced if they weren't hard to short.

In addition to the problems in the stock lending market, there are a variety of other short sale constraints. Regulations and procedures administered by the SEC, the Federal Reserve, the various stock exchanges, underwriters, and individual brokerage firms can mechanically impede

short selling. Legal and institutional constraints inhibit or prevent investors from selling short. Most mutual funds never go short.

Evidence for overpricing

A variety of evidence suggests that when stocks are difficult to short, they get overpriced. One example I have studied is battles between short sellers and firms (Lamont, 2003). Firms don't like it when someone shorts their stock, and some firms try to impede short selling using legal threats, investigations, lawsuits, and various technical actions. Consistent with the hypothesis that short sale constraints allow stocks to be overpriced, firms taking these anti-shorting actions have in the subsequent year very low abnormal returns of about -24 percent per year. The negative returns continue for up to three years. What appears to be happening is that these companies are overpriced, either because of excessively optimistic investor expectations, faulty products or business plans, or just plain fraud on the part of management.

Firms (either management or shareholders) can take a variety of actions to impede short selling of their stock. Firms take legal and regulatory actions to hurt short sellers, such as accusing them of illegal activities, suing them, hiring private investigators to probe them, and requesting that the authorities investigate their activities. Firms take technical actions to make shorting the stock difficult, such as splits or distributions specifically designed to disrupt short selling. Management can coordinate with shareholders to withdraw shares from the stock lending market, thus preventing short selling by causing loan recall. These battles between short sellers and firms can be extraordinarily acrimonious. The following statement from the sample I used gives a flavor of attitudes toward short sellers: "Your activities are mean, shameful and loathsome. They are motivated by appalling avarice and greed, and they will not be permitted to

go unanswered."

An example of the various anti-shorting strategies used by firms is provided by Solv-Ex, a firm that claimed to have technology for economically extracting crude oil from tar-laden sand. Short sellers claimed that Solv-Ex was a fraud. On 2/5/96, the management of Solv-Ex faxed a letter to brokers and shareholders: "To help you control the value of your investment…we suggest that you request delivery of the Solv-Ex certificates from your broker as soon as possible." This suggestion, entirely legal on the part of Solv-Ex, was essentially an attempt at market manipulation. The letter was an attempt to orchestrate a short squeeze using the stock lending system.

Any shareholder heeding Solv-Ex's suggestion would have withdrawn his shares from the stock lending market, potentially forcing short sellers to cover their positions. On 2/2/96, before the letter, Solv-Ex's price was at $24.875. By 2/21/96, the price had risen to $35.375, perhaps due to Solv-Ex's attempted squeeze. Solv-Ex took other action against short sellers as well. Later in 1996, Solv-Ex said that it had hired private investigators to find out who was spreading misinformation about the firm, and subsequently it filed suit against a well-known short seller, claiming he had spread false information. However, in this case it was Solv-Ex which was engaged in illegal activities, not the short sellers. Solv-Ex delisted at 7/1/97 at $4.25, amid an SEC investigation of whether Solv-Ex had defrauded investors. It entered Chapter 11 bankruptcy in 1997, and in 2000 the court ruled that the firm had indeed defrauded investors.

In this case, the evidence is consistent with the idea that Solv-Ex was overpriced in February 1996, since it subsequently fell sharply. My study, Lamont (2003), looks at long-term returns for a large sample of 270 similar firms who threaten, take action against, or accuse short

sellers of illegal activity or false statements. It turns out that (as in the Solv-Ex case) sample firms have very low returns in the year subsequent to taking anti-shorting action. Returns relative to the overall stock market are approximately -24 percent per year. The evidence is strongly consistent with the idea that short sale constraints allow very substantial overpricing, and that this overpricing gets corrected only slowly over many months.

While the underperformance of -24% per year is very large, it is similar in magnitude to the range found in other studies of stocks with very high short sale constraints, such as Jones and Lamont (2002), Lamont and Thaler (2003), and Ofek, Richardson, and Whitelaw (2002). Jones and Lamont (2002) find data for six years (1926-1933) while Lamont and Thaler (2003), and Ofek, Richardson, and Whitelaw (2002) studied data for a few years around the year 2000. Each one of these four data sets has unique characteristics, and it is conceivable that any one result reflects chance or an unusual sample period. But taken together, the evidence shows that in extreme cases where short sellers want to short a stock but find it difficult to do so, overpricing can be very large.

A notable feature of the data is that many of the sample firms are subsequently revealed to be fraudulent. A variety of other evidence suggests that short sellers are good at detecting and publicizing fraud on the part of firms (Dechow, Sloan, and Sweeney 1996, Griffin 2003). Again, recent events have emphasized the need to reward whistleblowers. The SEC and other regulators cannot be our only line of defense against corporate fraud. To protect investors, we need a vibrant short selling community.

Tech stock mania

Even absent corporate fraud, though, short sellers play an important role in protecting

individual investors from overpriced stocks. When informed traders are not able to go short, it will be small investors who unwittingly buy the overpriced stock, while the smart money stays away. For example, during the tech stock mania in 2000 there were some stocks that though clearly overpriced were not shortable for technical reasons. The victims were the individual investors who bought these stocks and suffered substantial losses. An example, documented in Lamont and Thaler (2003), is Palm, Inc. Palm was irrefutably overpriced in March 2000, but was difficult or impossible to borrow in the stock lending market, and thus could not generally by sold short. Institutions avoided owning Palm, and individual investors who blindly bought Palm suffered as it subsequently declined.

More generally, suppose we consider the possibility that Internet stocks were priced much too high around 1998-2000. Perhaps many investors thought that Internet stocks were overpriced during the mania, but only a small minority was willing to take a short position, and these short sellers were not enough to drive prices down to rational valuations. As a result, billions of dollars was wasted on uneconomic enterprises, millions of investors suffered losses, and hundreds of thousands of workers switched jobs only to see their new companies fail. It seems to me that the problem was not enough short selling in 1998 to prevent stock prices from reaching untenable levels.

Historical pattern

There is a natural tendency to feel that short selling is somehow inherently malevolent or un-American. To the contrary, it is quite positive for our economy to correct overpricing and detect fraud. And nothing could be more American than free speech, free markets, and a healthy competition among ideas and firms. If we are to have liquid markets that properly reflect

available information, investors must be able to buy and to sell.

Governments often restrict short selling in an attempt to maintain high security prices. Meeker (1932) reviews the attempts by a colorful cast of characters (from Napoleon to the New York state legislature) to ban short selling. Unfortunately, short sellers face periodic waves of harassment from governments and society, usually in times of crisis or following major price declines as short sellers are blamed. Short sellers are often thought to be in league with America's enemies. The general idea is that short selling is bad, and when bad things happen (such as war) it probably involves short sellers in some way. For example, the New York Stock Exchange imposed special short selling regulations during World War I (in November 1917), in response to both a substantial market decline and a fear that the Kaiser would send enemy agents to drive down stock prices. Jones and Lamont (2002) discuss another historical episode following the crash of 1929. The anti-shorting climate was severe in October 1930. President Herbert Hoover met with the president of the NYSE to discuss the situation and to curtail possible bear raids implemented via short-selling. The FBI's J. Edgar Hoover was quoted as saying he would investigate the conspiracy to keep stock prices low. Numerous anti-shorting regulations stem from this period, such as the uptick rule and the Investment Company Act of 1940 which placed severe restrictions on the ability of mutual funds to short.

This historical pattern has continued in recent years, as press reports indicate that authorities in Japan have sought to discourage shorting. Thankfully, in the past few years, Congress and the SEC have shown admirable restraint in not succumbing to the temptation to blame short sellers for the recent market decline.

Manipulation

It is of course appropriate for the SEC and other authorities to investigate possible manipulation involving short sales. But in general, there is no reason to believe that short selling is more likely, compared with other trading activity, to be used to manipulate stock prices. In fact, there are reasons to believe that short selling is less likely to be involved in illegal manipulations. There are even certain types of manipulation (such as "cornering" the stock) in which short sellers are the desired victims of manipulation.

Certainly, the big story from the past few years has been questionable behavior on the part of issuing firms, analysts, accounting firms, and underwriters. The short sellers have been the heroes of the past few years, alerting the public and the authorities to corporate fraud. And it has been the hedge funds which have simultaneously preserved investor capital and corrected mispricing.

Mutual funds vs. hedge funds

I believe that it would benefit both the efficiency of prices and the welfare of investors if more investors were to allocate their capital to strategies involving short selling, for example market neutral long-short funds. One way to channel more capital to short selling is to make hedge funds available to retail investors. It is sometimes thought that hedge funds are too risky for individual investors. Although risk is a complicated concept, I do not believe it is generally correct to say that hedge funds are more risky than mutual funds. Certainly, the experience over the past few years is that a long-short hedge fund was far less risky than a traditional long-only mutual fund that invests in tech stocks. Academic studies generally show that as a class, hedge funds can serve to reduce overall volatility in a diversified portfolio.

But the retailization of hedge funds is not the only way to accomplish this goal, since recent changes in the law have made it possible for mutual funds to go short. The Investment Company Act of 1940 placed severe restrictions on the ability of mutual funds to short, but the law changed in 1997, allowing mutual fund managers greater freedom to use derivatives and short sales. There are now mutual funds that have hedge fund-like attributes, such as the ability to go short and use leverage. These funds come with the full array of regulation, disclosure requirements, and investor protection.

In terms of policy, what should be avoided is a new set of regulations that subject hedge funds to the same rules as mutual funds, thereby limiting the freedom of hedge funds to exploit and correct mispricing. I fear that any new regulations might have the unintended consequence of making short selling harder than it already is, and consequently increase the level of mispricing and fraud in our economy. If policy makers feel that hedge funds are being inappropriately marketed to retail investors, the appropriate response is to raise the threshold for individuals to become an accredited or qualified investor in hedge funds. Individual investors who fall below the threshold can always invest in hedge fund-like mutual funds.

Recommendations

My opinion, therefore, is that we need to change the current lopsided system that discourages short selling. First, in the narrow technical arena, we should consider ways to make the equity lending system work better. It seems particularly unhelpful that (sometimes fraudulent) firms are able to abuse various aspects of the system in order to prevent short selling. Second, in the broader arena, we should continue to encourage the development of institutions that channel capital into short selling. Happily, there are signs of progress on both fronts, and as

more capital is devoted towards short selling it is likely that market forces will help improve the efficiency of the equities lending system.

Congress and the SEC will continue to hear complaints from companies about short sellers. As I mentioned earlier, the evidence shows that when companies and short sellers fight, it is the short sellers who are usually vindicated by subsequent events. For example, in 1989, the House Committee on Government Operations (Commerce, Consumer and Monetary Affairs subcommittee) held hearings about the alleged evils of short selling, featuring testimony from supposedly victimized firms. Officials from three firms testified. Subsequent to this testimony, the presidents of two of these three firms were charged with fraud by the SEC. Thus when you hear companies complain, keep in mind that short sellers are often the good guys.

Thank you for this opportunity to testify, and I would be happy to answer any questions.

REFERENCES

Dechow, Patricia M., Richard G. Sloan, and Amy P. Sweeney, 1996, Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the SEC. *Contemporary Accounting Research* 13, 1-36.

Griffin, Paul A., 2003, A league of their own? Financial analysts' response to restatements and corrective disclosures, working paper.

Jones, Charles M., and Owen A. Lamont, Short Sale Constraints and Stock Returns, *Journal of Financial Economics*, November 2002

Lamont, Owen A., 2003, Go down fighting: Short sellers vs. firms, working paper

Lamont, Owen A., and Richard H. Thaler, 2003. Can the market add and subtract? Mispricing in tech stock carve-outs, forthcoming *Journal of Political Economy*

Meeker, J., 1932. Short Selling. Harper & Brothers Publishers, New York.

Ofek, Eli, Matthew Richardson, and Robert F. Whitelaw, 2002, Limited arbitrage and short sales restrictions: evidence from the options market

Remarks to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing: "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

I first want to congratulate the Chairman, this committee, and its staff for the initiative they have taken in reviewing activities of short sellers and their relationship to the plaintiff's bar. For too long, their activities have flown below the regulatory radar screen. These include abusive tactics of the short sellers, lack of timely information on their activities and their unholy alliance with the plaintiff's bar. The result has been, in numerous cases, the manipulation of a stock downward and consequent loss by the affected company of access to capital markets, reduction in employment and shareholder value and a reduction in the Gross National Product. I want to make clear I am not including the majority of hedge funds who pursue legitimate hedging positions to achieve balanced portfolios. Instead, I have been following broker-dealers and short-sellers, for over 15 years, who seek to depress stock prices by disseminating false information about a company. This issue must be put in the context of the sparse, untimely short-selling data available to companies, the public and regulatory authorities. I am here not as an advocate for a specific client but for those clients who over the past 15 years have suffered from abusive short attacks coordinated with securities class-action law suits.

Thus the SEC's recent announcement of a review of hedge funds and short sellers should be applauded. The Wall Street Journal describes the industry as being "huge and lightly regulated." While there are obviously legitimate successful funds, those that use aggressive short-selling tactics demand a far higher level of scrutiny.

Some short sellers have long been known to use questionable tactics to depress prices and thereby manipulate the market. We studied a short seller who falsely accused a company of money laundering and organized crime ties to the FBI then tipped the press and TV news people of the "FBI's investigation." The media called and was told the bureau couldn't confirm or deny the story. Publication followed that falsely reported the allegations and investigation. Another short seller posed as a journalist to interview a company's vendors, clients, and analysts regarding the supposed impending loss of a crucial contract, license of permit or the threat of an imminent bankruptcy, all fabricated issues and designed to deflate the stock's price.

With the advent of instant, inexpensive communications through the Internet, the spread of false damaging information can infect Yahoo, Raging Bull or Silicon Investor chat sites, and a host of related web sites. A company's failure to monitor these sites can be a disastrous omission. In one matter, a short-seller posed as the chairman of a company predicting that quarterly results would be 50% less than expected. As a result, the company lost $400 million in net worth in just two weeks.

A company was charged with having used Arthur Andersen as its auditor overvaluing assets purchased in private sales. The company was able to counter-attack effectively and its stock did not decline drastically. At the same time, multiple class action security lawsuits were filed only to be dismissed later by a judge.

The risks and dangers posed by the short-selling community in this information age are exacerbated by weak reporting regulations. Specifically, information regarding short positions is limited to the monthly reporting of aggregate holdings. As someone once said, that's too little, too late. How ironic in these days of Sarbanes Oxley, and the call for more transparency that this monthly reporting standard still governs. What good was

a monthly report to the CEO who discovered in March that his short position had escalated from February's 900,000 to 14 million in 30 days.

Long curious about this absence of reporting information, I have asked a number of knowledgeable securities attorneys why more data is not made available. None knew. I asked if 13d filing requirements or restrictions on trading on insider information applied to short positions. The answer, "That's a good question."

Thus my conclusion is this is an area of trading that has simply been below the regulatory radar screen. Fortunately this Committee and the SEC are making an effort to review this sector to identify these kinds of issues.

The activities I have described are exacerbated by what I believe is a close unholy alliance between the short sellers and the plaintiff's bar. For example, certain short sellers have joined in a non-profit Hedge Fund Association "to unite the hedge fund industry and add to the awareness of the advantages and opportunities in hedge funds." Included on the board of directors, as representing hedge fund professionals is plaintiffs' attorney Randall Steinmeyer of the Milberg Weiss law firm. Click on the firm's name and you enter the firm's web site, which lists all current cases and past settlements, and victories of which there are many. (See Exhibit 1)

We have observed a strong correlation between companies subject to short-selling attacks and the rate at which those companies become defendants in class action lawsuits brought by plaintiffs' attorneys. In some cases, this is more than coincidence: there have been instances of collusion and communication between the short sellers and the plaintiff's attorneys.

In the seminal, well-documented Dynegy case, Dynegy employee, Ted Beatty believed he had learned of questionable trades and bank financing known as "Project Alpha." After the Enron disclosures, Ted Beatty told an acquaintance at Steadfast Capital, a short-selling hedge fund in New York City, that the power industry was dealing in questionable transactions. Shortly thereafter, Steadfast took a million dollar short position against Dynegy, which was arguably a trade made on inside information in violation of the law.

After Beatty left Dynegy, he received an email from Steadfast saying accounting issues at Dynegy would "make investor's fears go crazy and take the stock into a tailspin." In an April 3, 2002 article to which Beatty contributed, the Wall Street Journal raised questions about Project Alpha and Dynegy's financial reports. Based on conversations he had with principals of Steadfast, Beatty believes they knew in advance that the article was to be published, and increased the fund's short position in Dynegy beforehand.
To Steadfast's surprise, Dynegy stock went up slightly and the short sellers pressed Beatty to provide more details and documents relating to Dynegy's accounting. Beatty balked and provided only a summary for fear of a threatened lawsuit from Dynegy.

Allegedly in response to these concerns, Beatty was introduced to a Steadfast investor and principal, as well as another short-seller, who made it clear they wanted to enlist Beatty as the 'point man' to personally disseminate the Dynegy information to regulatory agencies, credit rating agencies and journalists.

Remarks to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing: "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

Beatty believes the short sellers wanted him to be the one to disseminate the information to make use of his credibility and because they wanted to conceal their own role and remain in the background.

To induce Beatty to disseminate the documents and information, the short sellers promised to effect personal legal representation and protection for Beatty via an introduction to Milberg Weiss.

John Stout, the Steadfast investor, then got another short-seller Tyler Burke, of Trenton Capital, on the phone and Beatty reiterated that he needed personal legal representation. Stout said Beatty should speak with Randall Steinmeyer of the San Diego office of Milberg Weiss.

On April 15, 2002, Steinmeyer called Beatty and asked to see the documents, indicating he could help the Beattys with their legal issues. Steinmeyer also said he was unhappy and frustrated about the Journal article's lack of impact on the Dynegy share price and that the reporters didn't understand the materials they had been given. Steinmeyer, in fact, called a Journal reporter and "berated him for the soft article."

In subsequent calls, Beatty continued to press Steinmeyer on providing legal assistance, but he instead continued to seek details about Dynegy and Project Alpha.

Beatty did provide the attorney with details and documents, at which time Milberg Weiss flew Beatty to San Diego for a meeting. At some point, Milberg Weiss paid approximately $7000 to Beatty for the information although they had promised "unlimited" consulting work at $250 an hour or a six-figure income, promises that were never kept.

Beatty learned that after he transmitted Dynegy documents to Steinmeyer the short-sellers had obtained them. Beatty believes that Steinmeyer was the conduit that provided the documents to the short-sellers. The Journal's second story on Dynegy appeared on May 9, 2002 based on the information provided by Beatty.

Again, at the request of short- seller Tyler Burke of Trenton Capital, Beatty contacted and provided information on Dynegy to the Internal Revenue Service, Standard and Poor's rating agency (which lowered Dynegy credit rating based on his information}, Moody's and Bloomberg wire service.

In addition, at the urging of both the short-sellers and Milberg Weiss, Beatty met with the Fort Worth SEC office. He was accompanied by a local attorney suggested by Steinmeyer who later also filed suit against Dynegy.

The Dynegy stock price finally declined after the SEC announced an informal inquiry and the next day Milberg Weiss filed their class action suit against Dynegy.

Beatty received a number of phone calls from Trenton Capital boasting of the profits they received from their short selling. Steinmeyer in fact told Beatty that short sellers earned profits of $150 million on short sales of Dynegy between April and May 2002.

Remarks to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing: "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

On November 25, 2002, the Wall Street Journal published a follow-up article, captioned "Whistle Blower Reels From Action's Fallout." This article described Ted Beatty's role as a whistleblower and detailed the Beatty's dealings with Randall Steinmeyer, Jack Pitts, John Stout and Tyler Burke.

When the Wall Street Journal was preparing the November 2002 article, it contacted Randall Steinmeyer and asked him how he knew how much the hedge funds had profited on Dynegy short sales. Steinmeyer immediately called the Beattys, furious and concerned that they had disclosed his relationship with short sellers. Steinmeyer told the Beattys that he did not want anyone to know about his ties to short sellers.

Steinmeyer told the Beattys that if the article ran with the revelation of Steinmeyer's and Milberg Weiss' ties to short sellers, the Beattys should not expect to have any further relationship or contact with the law firm.

The Wall Street Journal article ran[1] and noted Steinmeyer's connection to Steadfast but omitted mention of him knowing how much short sellers profited on Dynegy. After the article was published, Milberg Weiss terminated its relationship with the Beattys.

In sum, the Dynegy case stands as a litany of excesses-trading on material proprietary corporate information, inducing a current and later former employee to provide corporate information and documentation by promising employment which never materialized, misleading him into thinking he was being provided with personal legal representation when in fact the lawyer was interested only in obtaining information he could use in a class action suit and to assist the short sellers. If short sellers are acting in coordination with the plaintiff's bar, with tacit assurances that securities litigation will eventually be filed, inquiries must be launched to determine if insidious market manipulation is involved. Only then will the playing field be level.

I suggest the inquiry this committee and the SEC are pursuing will disclose an historical pattern of comparable incidents that have damaged American corporations, in many cases unfairly. While short selling is legal, more timely information on changes in short positions and the application of strictures such as 13d and insider trading now applicable to long investors should be equally applicable to short positions and will help curb the abusive practices clients have suffered over more than a decade.

I again thank the Committee for focusing on this vitally important issue for the health of our markets and to improve confidence in our economic system.

---

[1] See article attached below.

Dow Jones Interactive

Informer's Odyssey: The Complex Goals And Unseen Costs Of Whistle-Blowing --- Dynegy Ex-Trainee Encounters Short-Sellers and Lawyers, Fears Being Blackballed --- Seeking Justice and a Payday By Jathon Sapsford and Paul Beckett

11/25/2002
The Wall Street Journal
A1 (Copyright (c) 2002, Dow Jones & Company, Inc.)

Last January, Dynegy Inc. didn't give Ted Beatty the promotion he felt he deserved. So in February, the management trainee resigned, taking with him documents that suggested questionable accounting at the Houston energy company. His plan was to find another job and then expose the wrongdoing.

Part of that has gone as planned. Mr. Beatty and his wife, Maren, have watched as his documents, including details of a complex Dynegy deal called Project Alpha, led to the resignations of high Dynegy officers and ricocheted across the industry, prompting investigations of several other big energy traders. Dynegy has agreed to a fine and begun selling off assets in an effort to stay viable. It has been poetic justice for the Beattys, who say they are motivated by a desire to see right prevail.

But the rest of Mr. Beatty's plan has gone awry. He soon came to believe, as he tried to find a new job that the ex-employer he was seeking to expose was blackballing him and even breaking into his home. Mr. Beatty also found himself submerged in a financial-world subculture that has flourished amid this year's corporate scandals, one of plaintiffs' lawyers, regulators and short-sellers. All hoped to take Mr. Beatty's information and benefit from it, in different ways. Some, he says, assured him his assistance would earn him big money. But no such payout has materialized, and now, unemployed and in financial stress, he is feeling betrayed. "They all said they wanted to help me," he says. "I was dumb. I fell for it."

While every case is distinct, Mr. Beatty's venture into whistle-blowing is illustrative of the complex motives and unseen hazards that often lurk when insiders set out to air corporate secrets. Without a regular source of income, the Beattys made brazen, though unsuccessful, efforts to profit from what they knew. They lost money trying briefly to bet against Dynegy's stock. They asked regulators to hire Mr. Beatty to help them investigate the energy industry. They sought a reward from the Internal Revenue Service for exposing tax avoidance at Dynegy. Finally, Ms. Beatty even approached Dynegy's own board about hiring her husband, to help it root out other problems.

Still unable to find a job, Mr. Beatty blames not so much the weak economy and energy-sector layoffs as his former employer. In August, the Beattys became so sure they were being watched and harassed that they loaded a rented van and

moved to a small town in the Midwest. It's all far from the ending they expected when Mr. Beatty decided to take on the company.

"What did it accomplish?" asks his father, Jerry Beatty, an administrator at the Iowa Supreme Court in Des Moines. "I have a lot of reservations about what he did because I'm thinking about his family and security and employment. It wouldn't be so bad if it was just himself, but he's got three children and a wife."

Dynegy declines to comment on Mr. Beatty's actions, citing its "policy to protect the right to privacy of any current or former employee." But it says it never threatened him or sought to blackball or otherwise hurt him. "Dynegy denies taking any action to negatively hamper or influence the future opportunities for Mr. Beatty," says David Byford, a company spokesman. He adds that Dynegy is "disappointed Mr. Beatty didn't take advantage" of internal mechanisms for employees to report any concerns confidentially.

Ted and Maren Beatty met in 1998 at a pool in Iowa where Mr. Beatty, just out of the Navy, was killing time before starting work on an M.B.A. The two shared a love of swimming, hit it off and were married a year later. When Mr. Beatty, now 31, finished business school at the University of Texas in 2000, he joined Dynegy.

The Beattys soon ran into financial trouble because of a failed business venture, a swimming school they opened in their spare time. In September 2001, they filed for bankruptcy.

But at Dynegy headquarters in Houston, Mr. Beatty seemed to be doing well as he rotated through departments. One evaluation rated his work "outstanding," he says. An engineer with a blunt, rigid manner, he was unimpressed by some of his colleagues, who he says chafed at his habit of pointing out flaws in their work. "The people I dealt with weren't that smart," Mr. Beatty says of his superiors. "The fact that I could do their job, and they didn't want me to, bothered me." One year ago, after Dynegy briefly moved to take over troubled Enron Corp., Dynegy publicly portrayed itself as above the kind of questionable deals that brought down its larger cross-town competitor. It also said energy trading on DynegyDirect, its small rival to EnronOnline, had risen 20% since Enron's crisis began, in a "flight to quality."

Mr. Beatty, who had rotated through DynegyDirect, was skeptical. He still had a password for the system, so he took a look. What he saw seemed odd: The volume increase was based on four huge trades. Even stranger, these were two pairs of simultaneous trades that canceled each other out. They provided no apparent economic benefit but made volume look much bigger.

He printed out the trading records and took them to his boss, Anthony Carrino, a divisional vice president. "Keep quiet," he says Mr. Carrino responded. Mr. Carrino, who has left Dynegy, didn't return a call seeking comment.

A few weeks later, Mr. Beatty was among management trainees invited to lunch with Dynegy's president, Stephen Bergstrom. The group chatted about the turmoil from Enron's failure, and then Mr. Bergstrom casually mentioned that Dynegy was

beginning to restrict access to many of the internal files on its shared computer drive. He added that the process wasn't finished yet, according to Mr. Beatty. Mr. Bergstrom, who has left Dynegy, declined to comment. Mr. Beatty, already suspicious because of the trades he'd discovered, was curious about what the files might contain. When he looked, he found nearly impenetrable descriptions of a highly complex arrangement involving special-purpose vehicles and bank financing. It was Project Alpha, a deal that exaggerated cash flow from operations and cut taxes but was all but impossible for outsiders to fathom from Dynegy's public reports.

Mr. Beatty says he went to Mr. Carrino and was again told to keep quiet. He did so, Mr. Beatty says, but grew queasy about Dynegy, beginning to feel that company posters extolling integrity were hypocritical.

In January, that unease grew when he learned he wouldn't get a management post that he thought he'd been promised, which he expected would pay him more than $100,000 yearly. Instead, he says he was told his $84,000 salary would rise just $1,000. He complained to human resources. "I know I am a valuable person and my worth is much more than the offer you have given me," his Jan. 10 letter said. "I have been set back approximately 10 years professionally and monetarily." His complaint made little difference.

A month later, disgusted and demoralized, Mr. Beatty left Dynegy -- taking along the documents on the trades and Project Alpha. He went to Colorado to pursue job leads with utilities, "just hoping to start fresh on a new job."

Mr. Beatty had been sharing some of his thoughts about Dynegy with an old Navy buddy, Jack Pitts. Mr. Pitts worked at a New York investment fund, Steadfast Capital that since December had been "short" Dynegy's stock that is, betting that its price would drop.

On Feb. 27, Mr. Pitts wrote in an e-mail to Mr. Beatty that any sign of dubious accounting at Dynegy would "make investors' fears go crazy and take the stock into a tailspin." He also e-mailed Steadfast colleagues that "I think my friend Ted can really help us on Dynegy."

As Mr. Beatty recalls it, Mr. Pitts said that Steadfast Capital could help expose questionable dealing at Dynegy, simultaneously offering Mr. Beatty an outlet and Steadfast a potential profit. At one point, Mr. Beatty adds, Mr. Pitts half-jokingly told his friend he'd be famous once the story got out, maybe making the cover of Time magazine. Mr. Pitts, through a spokesman, declined to comment.

Mr. Beatty also says Steadfast Capital promised to hire him as a "consultant." The investment fund acknowledges it made money betting against Dynegy shares but says, "Steadfast denies ever having a consulting arrangement, verbal or written, with Mr. Beatty."

Then the Beattys jumped into the market themselves. Ms. Beatty says that in March she invested roughly $8,000 in "put" options on Dynegy, giving her the

right to sell the stock at a set price. The puts' value would rise if the stock fell -- a likely outcome if Project Alpha became known.

The Beattys say they felt uneasy about the move but did it because they needed money. "We felt like we had no other choice," Ms. Beatty says.

But "those options sat like a ton of bricks in our stomachs. They just added to the pressure we were under," she adds. Worried about violating insider-trading rules, they dumped the puts after just a few days. But because Dynegy shares had risen, not fallen, in the interim, the puts' value was now less. "We lost $2,400," Ms. Beatty says.

Mr. Beatty, in the meantime, had begun contacting newspapers, including The Wall Street Journal, offering to tell what he knew about Project Alpha. He initially asked whether he would be paid for his information. Told no, he agreed to talk about it anyway.

He soon heard from Dynegy. Ms. Beatty says an assistant general counsel of Dynegy, Cristin Cracraft, left messages for the couple saying "you'd better watch out" and "this isn't a game." They also got a letter from her saying Mr. Beatty was violating Dynegy employees' ethics code by disclosing confidential information, and warning that "Dynegy will be pursuing legal action in response to your conduct." Ms. Cracraft didn't return phone calls seeking comment. On April 3, The Wall Street Journal published a front-page article disclosing Project Alpha, based on Mr. Beatty's documents as a starting point and fleshed out with extensive interviewing of experts to make sense of the documents and corroborate them. For that article, the Journal agreed to maintain the Beattys' anonymity; since then, however, the Beattys have given express permission for their identity to be disclosed.

The article said that Dynegy, while acknowledging Project Alpha's financial benefits, contended its main purpose was to provide a stable source of natural gas. A "disgruntled former employee" had mischaracterized the complicated transaction, Dynegy's chief financial officer wrote later on a company Web site. The price of Dynegy's stock barely moved.

Steadfast Capital then arranged a phone call between Mr. Beatty and John Stout, a Steadfast investor. Mr. Beatty says Mr. Stout promised introductions to people in the financial community who would help "get the story out."

Mr. Stout doesn't recall saying that. He says he was just trying, at Steadfast's request, to find Mr. Beatty legal representation for his troubles with an angry Dynegy. The investor adds that he tried to arrange financial relief for Mr. Beatty by introducing him to people who could help him seek an IRS reward for exposing tax avoidance. "I was helping a friend of mine [at Steadfast] help a friend in need," says Mr. Stout.

Mr. Beatty says he did apply to the IRS, so far with no result. He says Mr. Stout's contacts also put him in touch with credit-rating agencies and other journalists. As for the lawyer Mr. Stout recommended, that person showed less interest in

helping Mr. Beatty with his Dynegy problem than in getting hold of the documents, Mr. Beatty says.

The lawyer was Randall Steinmeyer from Milberg Weiss Bershad Hynes & Lerach LP, a New York firm that files many shareholder lawsuits. Mr. Beatty gave him the Project Alpha documents. Soon after, Milberg Weiss filed a shareholder suit against Dynegy. The suit in U.S. District Court for the Southern District of Texas alleged that Dynegy, through Project Alpha, had "inflated the price of the company's stock in order to pursue an accelerated securities sale program." Dynegy says it will fight the suit.

Mr. Beatty says Mr. Steinmeyer told him that there might be consulting work for him over the course of the suit, which could be years. "He told me I'd end up making more money than he did," Mr. Beatty says. Mr. Steinmeyer denies saying this. Milberg Weiss has paid the Beattys about $9,250 for sporadic consultant work and continues to ask Mr. Beatty questions about his documents at times. But Mr. Beatty was expecting full-time employment.

Mr. Beatty says he won't get anything from a damage verdict or settlement in the suit because he isn't a Dynegy shareholder. He wonders if it has been worth being so helpful to people such as Mr. Pitts, Mr. Stout and Mr. Steinmeyer: "They all said they wanted to help me and they asked for the documents to help me -- or that's what they said."

In April, Mr. Beatty landed some consulting work at a Colorado utility, Platte River Power Authority. He impressed executives there and particularly hit it off with a project engineer, Bill Emslie, who, like him, had served on a Navy submarine. Mr. Emslie says he was sympathetic when told what had happened at Dynegy. "If he made known things that were being done that were not straight-shooting business arrangements, they need to be exposed. I applaud him for that," Mr. Emslie says.

Though Mr. Beatty discussed a permanent job at Platte River, none materialized. Mr. Beatty suspected Dynegy was blackballing him in the industry. Platte River's Mr. Emslie doubts that, saying, "He's probably carrying baggage with him from the job." Platte River executives say his whistle-blowing didn't make them uneasy, it was just that there were no appropriate openings.

In part to restore her husband's name, Maren Beatty began working the phones, asking Standard & Poor's and Moody's Investors Service if they wanted to speak with her husband about Dynegy. The credit-rating services declined. Then in late April, Dynegy disclosed that the SEC had begun an informal inquiry into its finances. The company also said that after consulting with the SEC, it had decided to reverse Project Alpha's effect on its cash flow.

The stock plunged 30% in a single day, delivering rich payouts to those who'd sold it short. Suddenly Mr. Beatty's documents were having an impact -- and the couple got nervous. Ms. Beatty says the pressure made them "probably totally paranoid."

Two days after word of the SEC inquiry, the Beattys woke up in their home outside Denver at about 3:45 a.m., both hearing what sounded like someone inside the house opening and closing drawers. They called the police and waited outside while officers inspected their home. "It was absolutely frightening," Ms. Beatty says.

Mr. Beatty made clear what he thought had happened. "I believe this was done by my previous employer Dynegy in Houston," he said, according to a police report filed with the Larimer County Sheriff's Office. "I have the documents at home that I took from the company. The company knows I have them." The sheriff's office concluded nothing had been taken. The case is in suspension, pending any further leads. Dynegy's Mr. Byford calls the notion that the company was behind a home break-in "absolutely absurd." About a week later, Mr. Beatty flew to Texas for a meeting with an SEC investigator. After a long meeting discussing his information about Dynegy, Mr. Beatty asked if the agency would hire him to do research on the industry. Rebuffed, he again felt betrayed. "The SEC was the worst in terms of people not being helpful after they get your information," he says. An SEC spokesman says the agency generally doesn't hire people for specific cases or pay for information.

Pressure on Dynegy grew. On May 9, The Wall Street Journal reported that the SEC was looking into "round trip" trades that served only to raise Dynegy's trading volume. Later that *month*, the U.S. Attorney *in* Houston subpoenaed Dynegy documents on trading and Project Alpha. And Dynegy announced it would reverse Alpha's tax benefits and revise 2001 earnings 12% lower as a result. In late May, Dynegy's board asked Chief Executive Chuck Watson to resign. Round-trip-trade revelations also led to resignations of senior executives at some other energy traders, including CMS Energy Corp. and Reliant Resources Inc.

But Mr. Beatty still didn't have a job. Increasingly anxious about money, his wife now took a radical step: In July, she contacted Dynegy itself about work. In a phone conversation with Charles E. Bayless, head of the Dynegy board's audit committee; Ms. Beatty complained that Dynegy had told investors and employees it would pursue her husband vigorously. Ms. Beatty then said he had evidence of other questionable practices at the company. According to a recording of the call, she asked if Dynegy's board would hire Mr. Beatty as a "consultant" so he could help the company find those other problems. An e-mail from Mr. Bayless makes clear the board considered doing so, but it ultimately declined. "We would be subject to criticism for doing anything that looked like we were paying a potential witness," he e-mailed the Beattys. Ms. Beatty says, "We had no intentions to blackmail the company. We just needed a job."

In mid-August, the Beattys say, they began getting mysterious messages they took as threats. They got anonymous one-word e-mails saying "Stop" and "Quit." Soon after that, the family rented a truck and started packing. In September, the SEC filed a civil securities-fraud case alleging Dynegy had presented "materially misleading information" to the public on Project Alpha and the round-trip trades. It also accused Dynegy of misleading investors by saying that a "disgruntled former employee" -- a reference to Mr. Beatty -- had mischaracterized Project Alpha.

Dynegy simultaneously settled the case by agreeing to pay a $3 million penalty, neither admitting nor denying the allegations.

People familiar with the matter say the SEC didn't press for a larger fine because Dynegy investors had already been punished enough. The shares, above $30 in March, now trade at around $1. Meanwhile, in October, the company said it would leave energy trading and refocus on power generation, natural-gas liquids and regulated utility businesses. "Dynegy is working hard to move forward," the company's Mr. Byford says.

The Beattys find the SEC action gratifying, in a way. Today, Ms. Beatty is working on a book about their experience, while her husband continues to search for steady work. At times, Mr. Beatty regrets ever deciding to take on Dynegy. "Sometimes I wish I never heard of Project Alpha," he says.

....

Exhibit 1

Contact Us | Careers

MILBERG WEISS

About our Cases | About Milberg Weiss

Case Finder: Company Nam

Current Cases | Settled Cases

The world's leading class action law firm

MILBERG WEISS BERSHAD HYNES & LERACH LLP

PRACTICE AREAS

- Securities
- Insurance
- Antitrust
- Consumer

INSTITUTIONAL INVESTOR

Milberg Weiss offers proprietary asset protection and recovery services to public, private and Taft-Hartley pension funds

Corporate Governance Bulletin - Second Quarter 2003.

Taking Action! Newsletter - April 2003

More Info

NEWS ROOM

Federal Judge Rules that IPO Securities Litigation can Proceed

Federal Court Rules to Keep Most Defendants in Enron Shareholders' Lawsuit

Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders (PDF), by William S. Lerach

More Info

NEW CASES

Case Name	Date Filed
Sara Lee Corporation (NYSE: SLE)	05/15/03
Allou Healthcare Inc. (AMEX: ALU)	05/07/03
Regeneron Pharmaceuticals, Inc (Nasdaq: REGN)	05/02/03
Alliant Energy Corp. (NYSE: LNT)	04/24/03
Orthodontic Centers of America, Inc. (NYSE: OCA)	04/23/03
NorthWestern Corporation (NYSE: NOR)	04/21/03
Fleming Companies, Inc. (NYSE: FLM)	04/17/03

More Cases...

Report a Fraud

FEATURED CASES

Hanover Compressor

Settlement of Hanover Shareholder Litigation Produces Unprecedented Corporate Governance Reforms & Recovery of More than $80 Million for Investors

AOL Time Warner

AOL & Time Warner Executives Accused of Pocketing Nearly $1 Billion in Insider Trading
Press Release (PDF)
Complaint (PDF)

Milberg Weiss Announces $600 Million Lucent Settlement one of the Largest in History

The Enron Fraud Website

More Featured Cases...

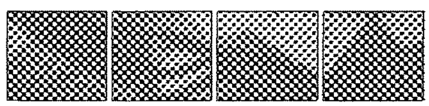
Site Map | Privacy | Legal

Hedge Fund Association

who we are

The Hedge Fund Association is an international notfor-profit association of hedge fund managers, service providers, and investors formed to unite the hedge fund industry and add to the increasing awareness of the advantages and opportunities in hedge funds. The founding president is Dion Friedland. The current Board of Directors is: **Representing hedge fund managers**: Peter Kash of Paramount Capital, Mayra Woo of ForstmannLeff Associates , Gary Parsons ofDingo Capital, Ron Bauer of The Bauer Partnershipand Howard Schachter of Schachter Capital Management. **Representing hedge fund investors**: Kevin Ferro of Ferro Capital LLC, Dion Friedland of Magnum Funds, George Van of Van Hedge Fund Advisors, Sergio Simone of RJS Private Wealth Management; and Andrew T. Malloy of OneCapital Management Partners. **Representing hedge fund professionals and service providers:** Michael Tannenbaum of Tannenbaum Helpern Syracuse & Hirschtritt LLP, Michael Lapat of Turn Key Hedge Funds Inc, Randall Steinmeyer of Milberg Weiss Bershad Hynes & Lerach, Carol R. Kaufman of Organized Systems Inc, and David E. Wulffleff of [illegible] Financial Inc.

As hedge funds still suffer from misperceptions about high risk and volatility (fueled in large part by media focus on sharp moves made by global macro hedge funds), the HFA aims to educate the investing public and legislators around the world on the true benefits as well as potential risks associated with investing in the different hedge fund strategies.



other objectives

- set industry standards for fund administrators and other service providers who collect, collate, and analyze information related to hedge funds
- provide a forum for the exchange of ideas to improve the effectiveness of association members (see our Web [illegible])
- lobby successfully at government levels in different countries to ensure that a wider universe of investors have access to hedge funds
- direct public relations for the hedge fund industry

member benefits

Our members enjoy:

- Access to a wealth of information, including database and library
- Great networking opportunities
- Free Link from HFA web site to member sites
- Meaningful HFA discounts resulting in "nocost" membership

Statement of

John F. Mauldin

President of
Millennium Wave Investments
Forth Worth, Texas

Before

The House Subcommittee on Capital Markets,
Insurance and Government-Sponsored Enterprises

Hearing on

"The Long and Short of Hedge Funds:
Effects of Strategies for Managing Market Risk"

Thursday, May 22, 2003

Chairman Baker, Ranking Member Kanjorski and members of the committee. I thank you for allowing me to share some thoughts on the important matter of who should be allowed to invest in hedge funds.

My name is John Mauldin. I am the president of Millennium Wave Investments, an investment advisory firm. I have been involved in the alternative investment world since 1989. I frequently speak on a wide variety of topics at hedge fund and institutional investor conferences. I write a free weekly e-letter which goes to over 2,000,000 readers on investing and global economic issues. A more complete bio is at the end of this statement.

It is my contention that the positive values that hedge funds offer to rich investors should also be offered to the middle class, within a proper regulatory structure. The current two class structure limits the investment choices of average Americans and makes the pursuit of affordable retirement more difficult than it should be. The rich have a considerable advantage in growing assets for retirement in that they simply have more assets to begin with. They should not also have an advantage in better investment choices.

Specifically, I will address the questions of: why should 95% of Americans, simply because they have less than $1,000,000, be precluded from the same choices as the rich? Why do we assume those with less than $1,000,000 to be sophisticated enough to understand the risks in stocks (which have lost trillions of investor dollars), stock options (the vast majority of which expire worthless), futures (where 95 % of retail investors lose money), mutual funds (80% of which underperform the market) and a whole host of very high risk investments, yet are deemed to be incapable of understanding the risks in hedge funds?

Let me briefly describe how we have come to the current situation. I will compare some of the investment opportunities, like mutual funds, to which average investors have access, with the performance of hedge funds available to the wealthy. We will look at the risks involved in hedge fund (and all) investments, and then suggest some ways in which the regulation of funds could be expanded to offer more choices.

First, let me point out that the current state of the hedge fund industry is the result of laws that were written in the 1930s and 40s, long before anyone ever thought of a hedge fund. The path that we have come down is not one of deliberate forethought, but a response on the part of entrepreneurial investment managers to improve investment returns for clients within the current regulatory framework. A quick history will illustrate this.

The first hedge fund was formed by Alfred Jones in 1952. He had the novel idea that by having a fund which could be long stocks he thought would go up in value and short stocks he thought relatively over-valued, that he could produce better risk adjusted returns for his clients. He also decided to keep a percentage of the profits he made for his

clients. Due to limitations imposed by Federal securities laws, the only available legal vehicle for him at that time was a private limited partnership. Thus he was forced to not advertise or publicly solicit investors. This became the pattern from which future hedge funds were cut.

As Fortune noted in 1966, his performance was better than that of any mutual fund.[1] This article, as a Fortune article in 1970 noted, created "almost overnight a raft of would-be hedge fund managers, most of whom were convinced that Jones had discovered the millennium."[2]

It also created the first calls for regulation. Again quoting, "...certain members of the SEC staff have already concluded that the Commission must take steps to regulate these funds... One staff member spoke recently of the 'crisis numbers' to which the funds have grown, and there has been much SEC talk about the 'impact' of the funds on the market."[3] Fortune estimated there were some 150 hedge funds by 1969.

As an aside, the article noted that investors were subject to strict suitability requirements. Thus, women were the most often persons rejected as investors. Remember, this was 1969. I would highly recommend this article as historical must-reading for all who are charged with the regulatory process involving hedge funds.

While we use the term "fund" when talking of hedge funds, I find it more helpful to think of individual hedge funds as businesses. The growth of the hedge fund industry since 1966 has been the result of investment entrepreneurs deciding, rightly or wrongly, that a particular investment strategy offered a certain type of return which would be attractive to some investors. Like any new business, if they satisfied their customers they prospered and grew. If they did not meet expectations, they went out of business.

The early hedge funds had a fairly limited range of strategies. As time wore on, different pioneers thought of new ways to earn absolute returns instead of the relative returns of the market. By absolute returns I mean actual profits at the end of the day. Investors in hedge funds do not want to hear the song of relative returns: "We are a good fund. The market is down 30% and you are only down 25%."

Today, there are dozens of different categories of hedge funds, with all types of objectives. Depending upon which information source you choose, estimates now range between 5,000 and 6,000 hedge funds

This growth has partially come about because of the availability of technology and a wide array of new investment opportunities. Stock index futures and interest rate futures were not introduced until the early 80's. Hedging interest rates and currency risks was very difficult as recently as the 70's. Today, it is done by many businesses as a routine matter. A reported 80% of the convertible bonds sold by US businesses to finance

[1] "The Jones Nobody Keeps Up With" Personal Investing, Fortune, April 1966.
[2] Loomis, Carol, 1970. "Hard Times Come to the Hedge Funds, " Fortune. January.
[3] Ibid.

their investments in the economy are sold to hedge funds. A whole host of derivative products have been created to help investors hedge certain types of risk.

But the most significant reason for the growth of the hedge fund industry is investment returns. Simply put, if high net worth investors and institutions could get the same returns as hedge funds by simply investing in stocks, bonds or mutual funds, why would they choose hedge funds which have higher fees, are hard to find and evaluate, and need more scrutiny? The answer is they would not. The demonstrably observable higher risk-adjusted returns make the effort worth it.

The key to this is the word "risk-adjusted." Hedge fund investors are not necessarily looking for higher returns. They are looking for strategies that can give them reasonable returns for the risks involved, or looking to lower the risks while getting potential steadier absolute returns.

We will now look at four types of mutual funds available to the average investor and the related performance of their hedge fund counterparts. We will look at US stocks, US bonds, international stocks and a specialty niche within both mutual funds and hedge funds called convertible bonds, which will give you some idea what hedging can do to the risks and returns for investors.

Before we look at the numbers, please understand that hedge funds are not investment nirvana. Investors can and do lose money. The data I show demonstrate that hedge funds do not always make money, even for longer periods of time. I am not contending that there are not substantial risks involved in investing in hedge funds. It is clear to anyone in the industry that there are.

My contention is that the risks are simply different than the substantial and generally known risks in normal stock and bond investing. It is not a matter of risk or no risk, it is more a matter of what type of risks would a prudent investor choose as appropriate for his portfolio. The availability of that choice should not be based upon the wealth of the investor but on his experience and competence. Wealth does not automatically confer superior investing skill and judgment.

Further, I would suggest it is no more difficult to understand the large majority of hedge fund strategies than it is to understand the business plan and risks of an investment in Cisco or other related technology company. Does anyone here believe that 99% of the investors in Cisco understand what a router does, whether China poses a threat to their business model and what their competition is likely to do?

Investors in Cisco have lost hundreds of billions of dollars. All told we have seen the evaporation of trillions of dollars from investors in the US stock market, yet no one suggests investors should not be allowed to invest in stock. Schwab recently reported that 40% of their clients did not realize that they could lose money in ordinary bonds. When interest rates begin to rise and bond investors lose money, will anyone suggest that investors not be allowed to invest in bonds because they do not understand the risks?

Critics of hedge funds typically cite that they are illiquid, highly leveraged, subject to a variety of uncertain market risks, subject to fraud, and the returns are highly volatile. I would readily agree with all those statements. But I have also just described the home real estate market. Additionally, homes are subject to termites, tornadoes, hurricanes and floods. Those of us who live in Texas know that home values can go down as well as up. Yet no one would propose that the average US citizen is not capable or smart enough to ascertain the risks of home ownership.

That being said, hedge funds pose different types of risks than homes, mutual funds and/or stocks. These are risks with which investors are unfamiliar, and thus to let investors into hedge funds without ample time to understand this new set of risks is not appropriate.

Let me briefly note that no essay on hedge funds should fail to mention Long Term Capital Management, along with the relatively few other large hedge fund failures. I would point out that Long Term Capital failed for precisely the same reason that the mutual fund Janus Twenty lost over ten billion dollars of investor's net worth: they had very well-known managers who built up highly concentrated positions which were very difficult to exit. Long Term Capital lost a few billion of investor money, much of which was the investment of the fund management.

Yes, there have been some outright frauds in the hedge fund world. They pale in size by comparison with the frauds committed by regulated public companies, perhaps a fraction of 1%. The established hedge fund investment community has a pretty good record of not investing in outright frauds.

I have provided in Appendix Three a brief essay on the risks in hedge funds and the due diligence process.

In Appendix One, I provide a series of charts and tables comparing certain mutual funds and indexes with their corresponding hedge fund counterpart. Let me briefly present a summary.

First, let's look at how hedge funds have done vis-à-vis the stock market and certain mutual funds. There are many different hedge fund strategies which are basically stock market strategies. I will use one of the more well-known hedge fund strategies: equity market neutral as represented by the CSFB/Tremont index. This style of long-short equity fund tries to eliminate the fluctuations of the market by precisely balancing long and short positions in stocks to avoid any market directional speculation. In Appendix Two I provide some notes on Market Neutral Investing

(There are indexes and hedge fund investment styles with better returns and with poorer returns, so it is possible to create either more or less favorable comparisons. But I believe this hedge fund investment technique or style is typical and representative. An

exhaustive comparison could take hundreds of pages, but would, in my opinion, produce the same overall impression.)

Equity Mutual Funds vs. Hedge Funds

First, let's compare the market neutral index with the S&P 500 (dividends included), as many investors use an S&P 500 index mutual fund as their proxy for the market.

Fund	Volatility	1 Year	3 Year	5 year	10 year
Equity Market Neutral (CSFB HedgeIndex)	3.14%	5.85%	8.06%	10.39%	10.69%
S&P 500	16.34%	-15.17%	-14.59%	-3.47%	7.75%

The typical S&P index fund had volatility[4] as measured by standard deviation of over five times the market neutral index. High net worth investors have watched their returns drop in the last few years, but are still comfortably in the black with this strategy. I am at a loss as to a reason for why investors should not be allowed to invest in such a fund strategy.

Let's compare hedge funds to one of the largest and most popular of mutual funds (name available upon request).

Fund	Volatility	1 Year	3 Year	5 year	10 year
Equity Market Neutral (CSFB HedgeIndex)	3.14%	5.85%	8.06%	10.39%	10.69%
Sample Large Popular mutual fund	17.13%	-14.26%	-14.13%	-2.10%	7.52%

(Volatility is based on monthly returns over 9 years annualized.)

Investors were well served by this fund during the bull market of 1982-2000. This fund seriously out-performed not only this index, but most hedge fund indexes in the recent bull market, rising 598 % from March of 1990 until March of 2000. Since that time, they have seen their assets lose over 42%. The annual volatility of this fund was over five times that of the average market neutral fund.

The management of this fund is some of the best available anywhere. However, they are limited to a long only strategy. You live by the bull and die by the bear.

Let's now look at one of the largest and most popular of technology funds, which invested in a highly concentrated portfolio of technology stocks (name available upon request). Management for the fund told investors it was their stock analysis which

[4] Volatility here is defined as standard deviation. Standard deviation quantifies the dispersion or scattering of returns around the average return for a given period. The higher the standard deviation, the more volatile the investment. Hedge fund investors typically seek lower standard deviations and steady performance. For this statement we use monthly returns over the entire period to produce an annual volatility.

enabled them to give investors very high returns. This fund was up 679% from March of 1990 until March of 2000. Since then, it has dropped 67%, cutting its return by two-thirds and costing average investors over ten billion dollars of net worth. Volatility was almost 8 times that of the market neutral index. This fund is by no means the worst performing technology fund. At its peak, it had over $25 billion, much of it from small investors. Which fund would they choose today if they had access to the market neutral funds available to the rich?

Fund	Volatility	1 Year	3 Year	5 year	10 year
Equity Market Neutral (CSFB HedgeIndex)	3.14%	5.85%	8.06%	10.39%	10.69%
Sample Technology Fund	24.98%	-8.05%	-27.63%	-3.96%	3.46%

Finally, let's look at the entire range of equity mutual funds[5] vs. the entire range of hedge funds. We asked Morningstar to give us an index of all equity mutual funds, and took the Tremont index of all hedge funds.

Fund	Volatility	1 Year	3 Year	5 year	10 year
CSFB/Tremont Hedge Fund Index	8.79%	4.98%	6.02%	5.84%	11.27%
Morningstar US Div Return	5.69%	-7.39%	-4.50%	-0.81%	1.03%

Let me again emphasize that hedge funds are not investment nirvana. Some hedge funds are very volatile and extremely risky, as are some mutual funds and stocks and futures. Some hedge funds are fairly stable and boring, as are bonds. Lumping all hedge funds styles into the same category can be very misleading. Simply because a person is a member of congress does not mean they are the same.

But just as voters get to choose the type of congressional representative they want, so too should investors be able to choose the type of funds and risk they or their advisors feel appropriate

Convertible Bonds

A popular hedge fund style because of its potential for steady returns is convertible arbitrage. A convertible bond is sold by a business. It pays an interest rate and is convertible into common stock at a specific price, usually much higher than the stock price at the time when the bond is sold. If the stock rises in price, the convertible bond becomes more valuable. However, it still pays interest until the time of its conversion. Thus it has the characteristics of both a stock and a bond.

[5] This is an average of all US diversified equity funds that fit with in the 9 Morningstar style boxes, which include growth, value, blend, small cap, mid cap and large cap. It excludes any hybrid funds that include bonds and sector funds.

A convertible bond arbitrage fund attempts to hedge out the risk of the stock portion of the bond by shorting the stock. They also typically use leverage to increase the returns. The leverage used varies widely from fund to fund.

Morningstar has an index of mutual funds which invest in convertible bonds. This is the typical return an average investor would have received from a long only strategy.

Notice what happens when appropriate hedging techniques are used. Returns are tripled over the last 5 years and volatility is halved. Why do we assume investors can understand the risks of investing in IBM and cannot understand this rather straight-forward process? Why should the average investor be denied access to this investment strategy if they want to invest in convertible bonds?

Fund	Volatility	1 Year	3 Year	5 year	10 year
CSFB HedgeIndex Convertible Arbitrage	4.84%	11.35%	10.81%	10.34%	10.93%
Morningstar Convertible Bonds	11.68%	-0.83%	-2.87%	3.32%	8.16%

Emerging Markets

In one of the most volatile and difficult markets anywhere, that of investing in stocks and bonds of emerging market countries, hedge funds have demonstrated a steady, if not spectacular, series of gains for their investors. For those investors who believe it wise to diversify into international stocks, which group of funds would the average investor prefer to have available?

Fund	Volatility	1 Year	3 Year	5 year	10 year
CSFB HedgeIndex Emerging Markets	18.27%	3.64%	5.80%	2.66%	6.00%
Morningstar Diversified Emerging Markets	23.48%	-15.11%	-9.85%	-2.41%	-1.44%

Government Backed Mortgage Bonds (Ginnie Mae's, etc)

Let's take the most prosaic and basic of investments: the Ginnie Mae bond. Again, hedge funds have outperformed their mutual fund counterparts. But that does not tell the whole story.

Fund	Volatility	1 Year	3 Year	5 year
CISDM Mortgage Backed Index	2.28%	8.29%	10.79%	9.78%
Morningstar Government Mortgage Index	3.08%	7.27%	7.87%	5.97%

Hedge funds have achieved their gains by hedging out the interest rate directional risks and use leverage to increase the returns. Mutual funds have achieved their gains by benefiting from the lowering of rates which causes the value of their bonds to rise.

What will happen when the economy recovers and interest rates start to rise? A rapid rise of 2% on a 30 year mortgage bond that sells for 5.3% today would cause the

value of the bond to drop 24.21%. Even a slow change could cause values to drop by 10-15%. That will cause the funds to lose money. Investors who thought they had a conservative government backed bond fund will find themselves with no returns.

Which is the better and more conservative approach to investing in Ginnie Mae bonds? Do you want to take the risk of rising rates or do you want the risk of leverage?[6]

The Hedge Fund Investment Company

Let me suggest the following: the creation of a new type of investment company vehicle. Simply modifying the current mutual fund rules might work, but it is not direct enough, in my opinion. Let's call this new vehicle a Hedge Fund Investment Company or HFIC. Let me describe it first and then outline some of the advantages.

A hedge fund would be allowed to register with the SEC or CFTC as an HFIC. They would be required to have an annual independent audit, at least quarterly independent valuations of their assets and independent administrators, plus they would be subject to SEC or CFTC advertising rules. There would be few, if any, limits on the strategy the fund could employ, and they could charge a management fee and an incentive fee. They would have to fully disclose not only the relevant risks, but full disclosure of information on their strategies, personnel and management experience.

As with mutual funds, there would be no limits on the number of investors. They would be allowed to advertise within current regulatory guidelines. With certain restrictions outlined later, they would be able to take non-accredited, or average, investors.

As noted above, hedge funds pose a set of different and unfamiliar risks than do stocks, bonds or mutual funds, not to mention futures, options and real estate, all of which are available to the average investor today. I would suggest that for a certain period of time, say 7-10 years, an HFIC be limited to investors who can demonstrate a required level of investment sophistication or to investors who use an investment advisor or broker who has passed an appropriate exam demonstrating competency in hedge funds (such as the Chartered Alternative Investment Analyst program sponsored by the Alternative Investment Management Association) or a sufficient number of years experience in the industry.

After the end of the period for investors to come to some understanding of what an HFIC is, as well as develop sufficient track records, these funds would then be available on an equal basis with mutual funds, stocks, bonds, futures, real estate, options and a host of other risky investments currently available to the average investor. This time period would also allow for a support industry and independent analysis firms to develop.

---

[6] There are other and quite serious risks of investing in Ginnie Mae bonds and hedge funds. I do not want to suggest these are the only risks.

The simple fact is that most institutional funds hire outside analysts to evaluate and recommend hedge funds. They also hire consultants and outside managers to recommend stocks and bonds. The actual individuals sitting on institutional and pension boards do not make the initial investments decisions, although the final authority is in their hands. I would suggest for your consideration that many of the people on these boards are not accredited investors. Yet they are considered capable of evaluating the appropriateness of whether or not to invest in hedge funds. The evidence is that increasingly large numbers of them are doing so.

They are no different than the individual smaller investor. If you create a situation where they can access appropriate sophisticated advisors, they will do so. Indeed, they do so now. There are tens of thousands of advisors and brokers who offer investment services to the public. They simply do not have hedge funds as a choice.

Would hedge funds willingly register? My belief is that they will. Because of my involvement in the hedge fund industry. To say that there are thousands of funds who are seeking money is not an exaggeration. The problem today is that they must do so privately and only to high net worth investors and institutions.

If they could approach a new class of investor I believe that many of them would do so. The current rules do not allow them to do so, and so they do not. It is not the desire of the industry to be secretive. It is the requirements of the law. Hedge fund managers certainly have no personal bias against small investors. The reason hedge funds avoid small investors is primarily legal. The large majority of managers simply want an appropriate amount of money to manage. If the rules allowed for appropriate and knowledgeable investing by smaller investors, they would adjust their programs to accept such.

A few comments on what might happen in the real world if such an investment vehicle as the suggested HIFC came about.

The likelihood is that a large majority of the initial HIFC funds would be existing fund of hedge funds. Many of these have long established track records and are well diversified. The process of taking numerous smaller investors would be no more problematic for a fund of funds than for a mutual fund. Certainly those funds of hedge funds who are registering under the currently available system anticipate taking many investors.

Secondly, I think it is likely to drive down fees over time. Just as the outrageously high fees of commodity funds came down in the 90's as more funds became available, and many mutual funds are available with quite low fees, I think you would see an investor friendly fee structure develop, especially for funds which are similar in nature.

The advantage of developing a new fund structure is that it does not displace the current status quo. If a fund wishes to remain private, they can do so. If they wish to go through the hoops of registering, that avenue would be available.

The reality is that the above disclosures I suggest are no more than what they already do today. If I or similar professionals cannot get the information we need to evaluate a manager, we simply do not invest. "Black Box" investing is an invitation for serious problems. Thus, as time went on, managers with good programs and steady risk-adjusted returns would realize that an HFIC requires no more than their current high net worth clients are requiring on a private basis today. The HFIC would simply be seen as another way for raising funds.

Finally, funds should have the choice of whether to be regulated by the CFTC or the SEC. The CFTC currently regulates 55 out of the 100 largest hedge funds since they are registered as commodity pools. Patrick McCarty, General Counsel for the CFTC noted at the SEC Hedge Fund Roundtable last week that out of the 2400 funds registered with them, they had only 10 complaints last year. If an HFIC uses futures, then they should be allowed the choice of which regulatory authority to choose, but not be subject to duplicative process which force extra expense.

The good news for investors is that over time they would be able to access these funds now only available to the rich. I should point out, that even though the rules say an Accredited Investor is someone with $1,000,000 or more, that does not mean that on a practical or legal basis they can access the large majority of hedge funds. On a practical basis, a net worth of $5,000,000 or more is required before you can begin to avail yourself of many of the better managers, and the top funds which have high minimums often have a much higher practical requirement for net worth.

This new industry would grow slowly, as did mutual funds when they were first offered. Over several decades, I would suggest that they would become standard fair for investors. They would not replace mutual funds or other investments. They would simply be one more choice, just as they are now for the rich.

In summary, let me say that we should evaluate the decision whether or not to allow smaller investors the same rights as larger investors in the light of three questions:

1. Is it appropriate?

The premise of Modern Portfolio Theory is that you can increase the returns and decrease the risk of an investment portfolio by adding non-correlated investment asset classes, even if those individual classes are individually highly volatile. Many hedge funds styles, by any reasonable assessment, are highly uncorrelated with the stock and bond markets. High net worth individuals and institutions are taking advantage of this fact by diversifying a part of their portfolio into hedge funds. This reasonable diversification should be made available to smaller investors as well.

No one would suggest that all or even a significant proportion of an investor's portfolio should be in hedge funds. But a reasonable diversification is appropriate.

There is no real reason to believe that smaller investors cannot understand hedge fund strategies if properly explained. If investors can be assumed to understand the risks involved with individual US stocks, foreign stocks, commodity futures, currencies, options, mutual funds and real estate, not to mention a host of Reg D limited partnerships, then how can anyone suggest that hedge fund strategies are beyond the ken of investors?

I would suggest that investors can understand quite readily the logic and value of hedging the interest rate directional risk from a bond fund, or pairing under-valued and over-valued stocks, or hedging a convertible bond. While management competence is the real issue investors should focus on, how difficult is it to understand the concept behind buying under-valued assets in a distressed debt fund?

A hedge fund is a business, generally with a straight-forward premise. It is no more, and often far less, difficult to understand than the business risks and plans of typical US based company, to say nothing if a bio-tech or high tech firm or international company than the risks and concepts of a typical hedge fund.

2. Is it the right thing to do?

Most hedge funds have an offshore version with lower minimums. The reality is that investors from Botswana have more and better investment choices than do US citizens from Baton Rouge, Louisiana.

If you ask the brokers and investment advisors on the front lines of serving the public whether they wish they had access to hedge funds on behalf of their clients during this last three years, the answer would be a large yes. If you ask investors whether they should be able to make their own decisions – to have the same choices as the rich - the answer would also be yes.

The only people who benefit from limiting investor choice are those who have a vested interest in not facing the competition from hedge funds. As they seek to protect their turf, they have lost sight of the interests of those whom they should be serving.

Those who oppose allowing average investors to have the same choices as the rich must tell us why smaller net worth investors are less intelligent or are deserving of less options than the rich. They should show why average investors should only be allowed funds which are one way bets on an uncertain future.

I believe that investors would tell you that not allowing them the same choices as the rich is the type of government protection that they do not need.

3. Is it fair and just?

With all the proper regulatory scrutiny being devoted to hedge funds, with the concern of hedge funds that such activities could restrict their investment options and business, it would behoove us to remember the small investor, who is not even allowed a

hedge fund crumb from the rich man's table. The focus of future regulation should be to make sure there is an honest game on an even playing field, not to exclude certain classes of citizens.

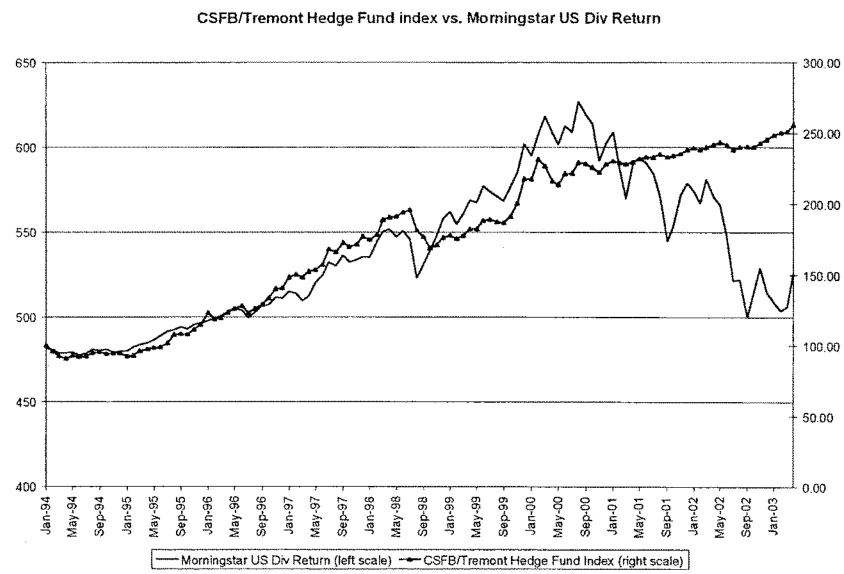
To put it simply: it is a matter of Choice. It is a matter of Equal Access. It is a matter of Equal Opportunity.

I believe it is time to change a system where 95% of Americans are relegated to second class status based solely upon their income and wealth, and not on their abilities. It is simply wrong to deny a person equal opportunity and access to what many feel are the best managers in the world based upon old rules designed for a different time and different purpose. I hope that someday this committee will see to it that the small investor is invited to sit at the table as equals with the rich.

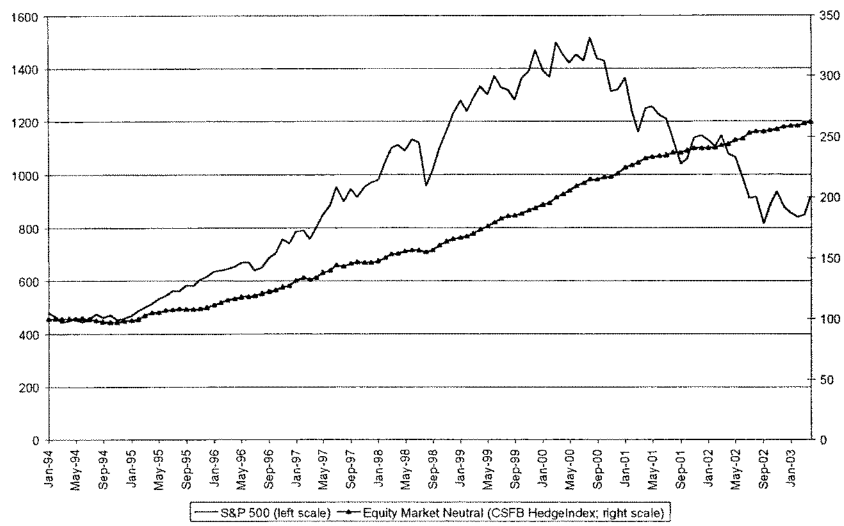
Mr. Chairman and members of the committee, thank you for your time and indulgence.

Appendix One

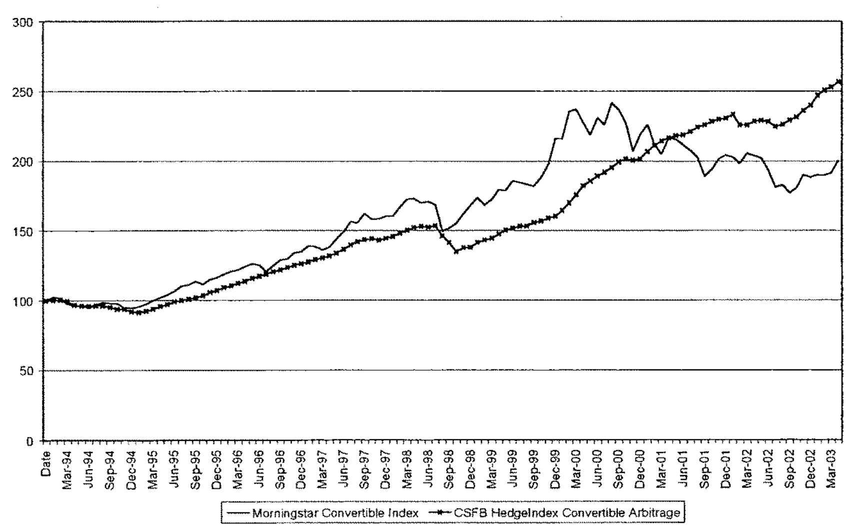
The following are charts of the tables presented on pages 5 through 8



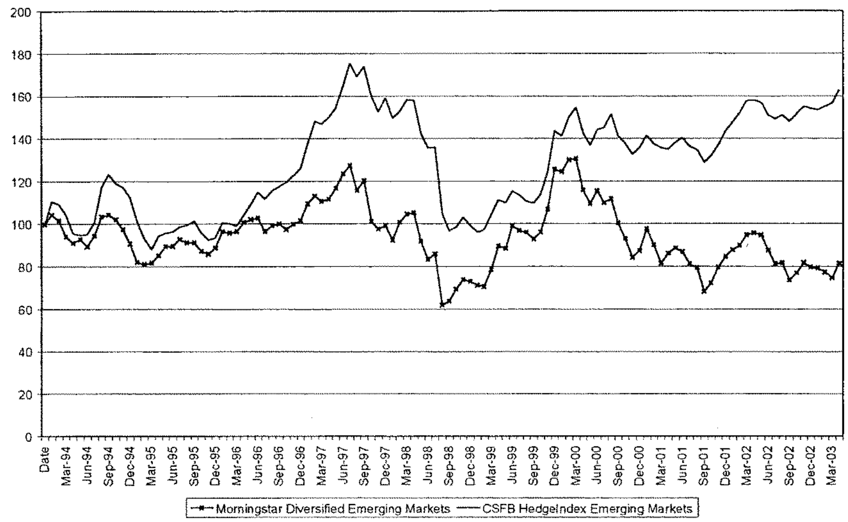
Equity Market Neutral (CSFB HedgeIndex) vs. S&P 500



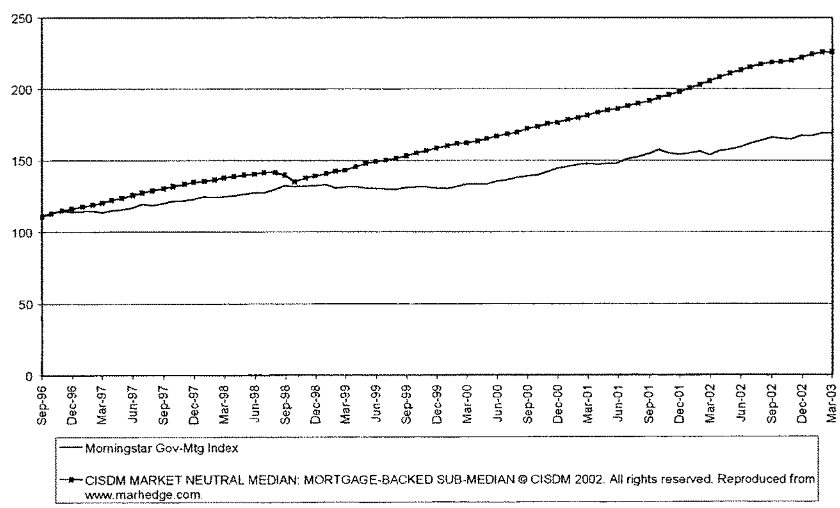
Morningstar Convertible Bonds vs. CSFB HedgeIndex Convertible Arbitrage

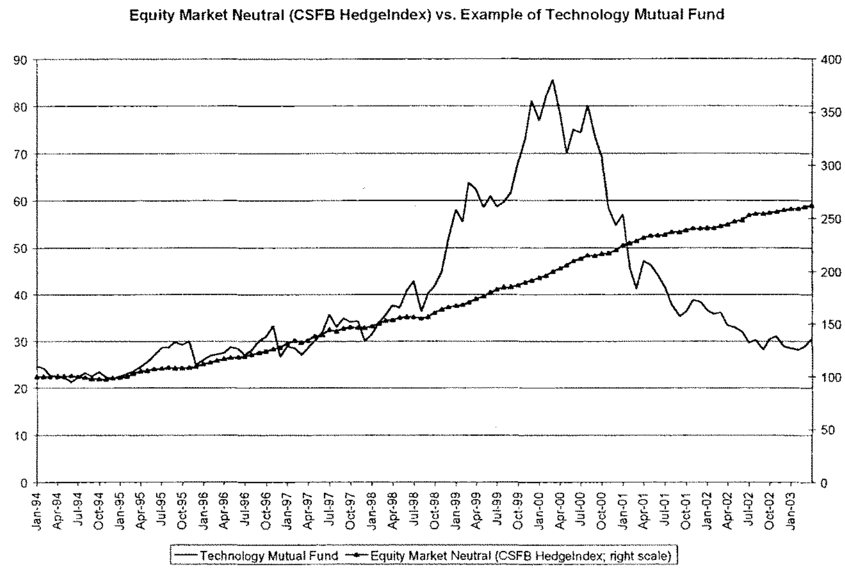


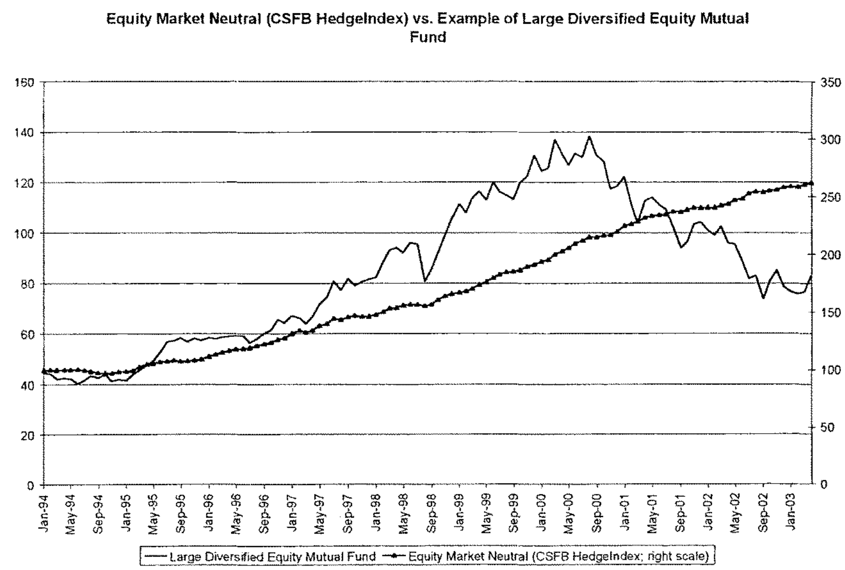
Morninstar Diversified Emerging Markets vs. CSFB HedgeIndex Emerging Markets



Morningstar Government Mortgage Index vs. CISDM Market Neutral Median: Mortgage-Backed Sub-Median




Equity Market Neutral (CSFB HedgeIndex) vs. Example of Technology Mutual Fund
Technology Mutual Fund
Equity Market Neutral (CSFB HedgeIndex; right scale)


Equity Market Neutral (CSFB HedgeIndex) vs. Example of Large Diversified Equity Mutual Fund
Large Diversified Equity Mutual Fund
Equity Market Neutral (CSFB HedgeIndex; right scale)

Appendix Two: Market Neutral Funds

Market neutral funds are a sub-set of long short equity funds. There is an additional layer of constraint that can be used in long/short and that is to make the strategy also market neutral. Market neutral tries to eliminate the fluctuations of the market and depend purely on the manager's ability to produce "alpha" (absolute returns over the index) while the long/short strategy can move from net long to net short depending upon the manager's decision. William Sharpe, the inventor of the Sharpe Ratio, had this comment to say:

> "I favor market-neutral strategies for certain kinds of active management, if the costs can be kept low, since they allow separation of asset allocation decisions from stock-picking decisions. Thus an investor can use index funds and/or derivatives to achieve a desired asset allocation, then invest in market-neutral funds to the extent that he believes some of them can add value without excessive added risk." [from Market Neutral: Engineering Return and Risk]

There are two ways to structure the market neutral strategy for equities, Beta neutral and dollar neutral.

Beta Neutral

Beta neutral is a long/short that uses complex statistical models to try and be market neutral. The manager will use a calculation of the stocks beta to determine the right ratio of long to short to achieve market neutral. The Beta of a stock is based on the historical volatility of the stock in relation to the overall market. The market has a Beta of 1 and more volatile stocks like growth stocks will have a Beta greater than 1, while less volatile stocks like value stocks will have a Beta less than 1. The stock with the beta above one in theory will go up or down more than the market and the stock with the low beta will go up or down less than the market. This one will require an illustration (assume the portfolio is valued at $10,000):

Stock A has a Beta of 1.5
Stock B has a Beta of .75
Put 33% of your portfolio in stock A ($3,333)
Put 66% of your portfolio in stock B ($6,666)

This gives a Beta of 1, which will match the market.
1.5 * .33 = .50
.75 * .66 = .50
1 = Portfolio Beta

Short stock A and go long stock B then if the overall market goes up 30%:
Stock A goes up 30% * 1.5 = 45.0% to $4,833
Stock B goes up 30% * .75 = 22.5% to $8,166

Stock A has a loss of $3,333 - $4,833 = ($1500)
Stock B has a gain of $8,166 - $6,666 = $1500

The beta neutral position has caused the portfolio to have the same loss in both positions due to the weighting based on Beta instead of weighting based equal Dollar. If the trade had been done with $5,000 allocated to both positions the portfolio Beta would be 1.125 instead of 1 and produce a ($1,125) loss if the market went up 30%. The manager makes money by correctly predicting the movement of these two stocks compared to each other, as the market risk has been hedged away.

Dollar Neutral

This is similar to the beta neutral example but the manager puts equal dollar amounts on the long and short. So the manager could be long a financial company stock like Citigroup by $100,000 and be short a financial stock like JP Morgan by $100,000. This trade will not be beta neutral if the two stocks have different betas. The other thing to realize is that depending on where the share price is trading the manager will be going short a different number of shares than he is going long. At the time of the writing JP Morgan is trading close to 30 and Citigroup is close to 40, so for dollar neutral to be achieved the manager would buy 3333 shares of Citigroup and sell short 2500 shares of JP Morgan.

Appendix 3 – Due Diligence on Hedge Funds

It's not what we know that will cause problems for our investments. It's what we don't know that always causes the disasters.

Due diligence is the process of investigating a fund or investment opportunity before you invest. It is the most important element of the investment process, and for many investors the one most ignored.

It is helpful to think of a hedge fund as a business. Investors would not invest in a business without asking a lot of questions, learning about the management and trying to decide if the potential returns were worth the risk. Essentially, all due diligence boils down to these three basic questions:

1. Is Management honest?
2. Is Management competent?
3. Does the investment strategy have the potential to do well in the future?

All three questions are critical. Let me briefly touch on the third. We have all read the sentence "Past performance is not indicative of future results." It should not be read as boilerplate language. It is the single most critical aspect of successfully investing in a fund or business.

Every fund management style will have periods of good performance. Many are very dependent upon market externals. By that, I mean if the conditions are not right, they will not make money, and may even lose a great deal. Simply investing by the numbers may not produce good results. It often – quite often - produces very poor results.

You cannot determine the above solely by reading the offering memorandum or fund marketing materials. What fund offering material says, "We are liars" or "We don't know what the hell we are doing"?

Every hedge fund, mutual fund and public stock manager will tell you "now is the best time to invest." So do most of the professional analysts.

It is important to read the offering memorandums to get a basic understanding of the fund or business structure. But that is the beginning, not the end, of the process. You will seldom get the information you need to adequately determine whether or not you should invest in a fund in offering documents, or even adequately determine the real risks to your investment.

Let's be perfectly blunt. That long offering memorandum and subscription agreement one signs is not to protect investors. The disclosure documents sent to you by mutual funds AFTER you have given them your money will not help you understand what market risks you are really taking. It is to protect the fund in case something goes wrong. Attorneys are paid large sums to think of every possible risk imaginable and then

include them in the offering document, getting you to acknowledge you understand the risk. If a creative attorney thinks of some new risk or disclosure and puts it in a new offering document, that paragraph will soon start to appear in every other new document.

Offering memorandums are VERY important. Read them. Jot down questions as you do. Just remember they do not answer the most important questions.

Far more of your investment success will come from picking the right investment strategies (by this I mean broad asset classes) than by picking the right fund or stock. That being said, it would be very sad if you pick the right strategy but still fail because you do not do your homework on the fund or stock in which you invest.

It's 10 PM. Do You Know Where Your Investment Is?

"Hedge fund investors don't always understand what they're investing in. According to a study by Prince & Associates, three-fourths of the 384 affluent hedge fund investors surveyed didn't know their hedge fund's investment style or if they used leverage. And according to the study, those who didn't know, didn't want to know. But it makes for good cocktail chatter. Just pass the shrimp, please."[7]

In almost every case of hedge fund fraud, the investors simply did not do their homework. If investors went through a due diligence process like the one I describe, it is highly unlikely they will end up in a fraud. (Just to set the record straight, investor losses from hedge fund frauds are a tiny (less than 1%) fraction of the frauds just recently discovered on Wall Street.)

The far larger risk to your money is not fraud, but incompetence or poor management. Investing in hedge funds without proper due diligence is like throwing the dice. Maybe you get lucky, but more likely you will end up unhappy, at the very least.

If you go through the process, it is much more likely you will end up with a fund that is a match for your goals, and fits into your investment philosophy. You won't be having to jump from fund to fund, chasing last year's earnings. You will know what to expect, and won't get nervous when the occasional drawdown occurs. You will also have an idea of what situations – and not your emotions -- will cause you to exit the fund.

Finding a good hedge fund is not easy. There is no Morningstar of hedge funds like there is for mutual funds. It is not that there are not a lot of hedge funds, but that there is no central source for listing funds. Industry sources tell us there are at least 6,000 hedge funds and private pools by the latest estimates, and some knowledgeable industry analysts now put that number closer to 7,000. My guess is that less than a third are in the public databases. (A third of the hedge funds in my fund of funds do not list themselves in the public databases.)

---

[7] Rich Peebles from www.prudentbear.com
http://www.prudentbear.com/archive_comm_article.asp?category=Market+Summary&content_idx=12111

I recently saw a study which analyzed two public hedge fund databases of over funds, but there was only 30% overlap between the two databases. There was only a combined 2,000 unique funds in both databases. This all goes to say that finding a good fund is hard work.

There are a variety of styles among hedge funds. Finding the style that is right for your investment needs is critical. Some hedge funds managers are good and some are just lucky. You do NOT want to invest in the lucky one, as luck always runs out, typically just after you invest. There are any numbers of ways that managers can hide problems in their management styles. It is important to uncover them before you invest. Hedge funds are businesses. The business side of the fund is just as important as the investment side. Are the managers good businessmen as well as smart investors?

The Due Diligence Process

Institutional investors, family offices and hedge fund analysts like myself usually have a lengthy list of questions we ask to prospective hedge funds. These questions are designed to give us the information we need to evaluate the fund. Further, they help us decide between funds which are similar in style and performance. There are hundreds of market neutral and long-short equity hedge funds. Choosing between one or another can be difficult.

As an example, I might want a 15-20% exposure to convertible arbitrage in my fund. There are scores of such funds, and a number of them may make it through the initial screening rounds. On the surface, the funds may look alike. They may even have similar trading styles. What would make me choose one fund over another? Which fund has the best "edge"? In many cases, it comes down to comfort levels. How much confidence do I have that my money (and that of my clients!) is being managed well and is safe?

In the process of writing this essay, I sent an email to a number of my friends in the hedge fund community, and asked them to send me their due diligence questionnaires. I also asked a number of hedge funds to send me some of the questionnaires they get which they thought were particularly good. As you might suspect, the majority of the questions were similar. But what was interesting to me were the differences.

Most of the forms had one or two sets of questions designed to ferret out a particular set of issues or problems. My deep suspicion is that these differences were brought about by the authors having experienced an unpleasant relationship, and the questions were designed to avoid that problem in the future. I must confess that my own forms were not an exception to this rule.

I began to compile and organize the questions into one due diligence document. I was amazed at the length of the document as I finished. I decided I must cut the number of questions down, as they numbered over 100, and many were multi-part.

The problem was, however, that as I reviewed the document over a few weeks, each piece of information was important, and gave further insight into the company or comfort about the safety of your money. There was not one question I wanted to delete, and again I must confess I added a few more questions as I thought through the process.

The questions are designed to give us insight into the fund on several different levels. The most important thing to understand about a fund is "Why" it makes money. If you cannot understand the "Why" of a fund, you should not be investing. This is the critical question that will help you understand what the dominant factor in performance of the fund is: skill or luck. As I stated earlier, luck always runs out, typically just after you invest. More funds are based upon luck or random chance than you might think, but I can guarantee you no fund manager will admit it, and most of them would be insulted if you said so. Genius is a rising market, and good performance has persuaded more than one manager they are geniuses. Avoiding such genius is crucial to capital preservation. Finding true investment ability (genius or not) is the secret to capital growth.

The next most important question is "How" the fund makes money. What are the strategies and systems used, and what is the risk taken?

If you can get a good feeling about those two questions, then you follow up with the more mundane but critical questions of "Who", operational issues, structure, safety of assets and, of course, performance.

****

For those who would like a more detailed analysis of how to do due diligence on hedge funds and investments in general, I have posted a list of the due diligence questions along with my commentary on them. Interested parties can find this document at http://www.absolutereturns.net/chapters.htm .

John Mauldin

A recognized expert and leader on investment issues, Millennium Wave Investments president John Mauldin is primarily involved in private money management, financial services, and alternative investments.

Millennium Wave Investments is a state registered investment advisor and is registered with the CFT as a Commodity Pool Operator/ Commodity Trading Advisor. Mauldin is a registered representative of Williams Financial Group.

John is a prolific author, writer and editor of the popular Thoughts from the Frontline newsletter which goes to almost 2,000,000 readers weekly, and is posted on numerous independent websites. He is also a frequent contributor to other financial publications, including the Fleet Street Letter. His new book, "Absolute Returns", due out in Q3 of 2003, will pull back the curtain on the world of private offerings for individual investors. (To view some chapters today, go to (www.absolutereturns.net).

Investors can visit his website at www.2000wave.com or subscribe to his free weekly e-letter by sending a request to john@2000wave.com. Accredited investors can receive his free monthly letter written especially for them at www.accreditedinvestor.ws.) further information on Mauldin can be found at www.johnmauldin.com .

John demonstrates an unusual breadth of expertise, as illustrated by the wide variety of issues addressed in-depth in his writings. He has a unique ability to present complex financial topics and make them understandable to the lay reader. His background includes a wide variety of studies and experiences and he has traveled extensively. John speaks at numerous investment conferences and seminars. These range from small gatherings focused on high net worth individuals to large conferences geared to average investors.

John is a Fort Worth, Texas businessman, married to his wife Eunice (she is John's favorite Canadian import) and the father of seven children, ranging in age from 8 through 25, five of whom are adopted. He graduated from Rice University in 1972, with a Bachelor of Arts degree and from Southwestern Baptist Theological Seminary with a Master of Divinity in 1974. From 1982 to 1987, he was Chief Executive Officer of the American Bureau of Economic Research, Inc., a publisher of newsletters and books on various investment topics, from 1982 to 1987. From 1989 until 2000, he was a partner in ProFutures Investments. He sold his interests in ProFutures to start Millennium Wave Investments in 2000. He was one of the founders of Adopting Children Together, Inc., which was at that time the largest adoption support group in Texas. He currently serves on the board of directors of The International Reconciliation Coalition and the International Children's Relief Fund. He is also a member of the Knights of Malta, and has served on the Executive Committee of the Republican Party of Texas.

When considering alternative investments, including hedge funds, you should consider various risks including the fact that some products: often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. And always, without fail, remember that past performance is not indicative of future results.

DAVID A. ROCKER

Managing General Partner, Rocker Partners, L.P.

Presentation to the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

May 22, 2003

My name is David Rocker and I am the managing general partner of Rocker Partners, L.P., a New Jersey based hedge fund[1]. I am honored to have this opportunity to address the House Subcommittee on Capital Markets to offer my views on hedge funds, short selling and the appropriateness of possible additional regulation.

Rocker Partners is an eighteen year old firm with a contrarian style. While we maintain both long and short positions, we have focused our research efforts more heavily in recent years on short selling because we have identified more stocks which we have felt were overvalued than those which we felt were attractive. We are generally viewed as a specialized manager and our investors, primarily wealthy families and institutions such as universities, hospitals and endowments, often use us as a risk-reducing hedge against their long biased investments.

Hedge funds have grown rapidly because they have served both of their constituencies, investors and managers, better than more conventional alternatives. Over the last six years, which encompassed both the expansion of the equity bubble and its subsequent deflation, an investment in an average-performing mutual fund would have remained essentially unchanged, but the same investment in an average performing hedge fund would have appreciated approximately 75%, and would have done so with lower volatility. Investors have also been attracted to hedge funds because of the greater identity of interests between the fund manager and the investor. Substantial personal assets of hedge fund managers and their families are typically co-invested alongside limited partners, and such investments typically represent a much higher percentage of the total assets under management than is the case in mutual

[1] Prior to founding Rocker Partners, L.P. in 1985, I was a general partner of Century Capital Associates, a registered investment adviser I joined in 1981. Prior to that, I was a general partner of Steinhardt, Fine, Berkowitz & Co., a hedge fund I joined in 1972. From 1969 to 1972, I was a research analyst and investment banker with Mitchell Hutchins, Inc., a registered broker-dealer. I was graduated from Harvard College magna cum laude in 1965 and received an M.B.A. with distinction from Harvard Business School in 1969.

funds. Hedge funds frequently provide a more attractive financial opportunity for successful managers. The broader investment flexibility available in a hedge fund structure has also proven appealing. Many former mutual fund managers have joined or started hedge funds in recent years.

While there is considerable discussion as to whether hedge funds require greater regulation, it is important to recognize that even unregulated funds are already subject to a substantial degree of oversight by their investors. Fund investors, especially in mature funds such as ours, impose tremendous demands on managers with whom they choose to invest, including, among many other things, that the fund has formal compliance policies, appropriate restrictions on employee trading, some amount of investment transparency, specific risk management techniques, operational proficiency, and a whole host of other protective requirements. The hundreds of billions of dollars invested in the hedge fund marketplace require, as a matter of fund Darwinism, best practices to be employed by hedge funds, and those managers that do not or can not provide these protections to the investor marketplace generally do not succeed or survive. Additionally, the co-investment of the hedge fund manager's personal and family assets helps serve as a self-governing mechanism.

The highly publicized hedge fund blow-ups in recent years must be placed in perspective. Such funds have represented fewer than ¼ of 1% of the industry and the superior investment results cited earlier include the losses from these entities. As the present structure has served investors well during both rising and falling markets, I believe additional regulation is neither necessary nor desirable. Existing regulations, effectively applied, coupled with the extensive due diligence and operational requirements of large investors, have proven sufficient to date. Anyone willing to commit fraud will not be deterred from doing so by a registration requirement. With few notable exceptions, hedge funds have proven less risky than conventional alternatives, so the present focus on them is somewhat puzzling.

The issue of retailization raised by Commissioner Donaldson, among others, merits careful consideration. On one hand, most present investors in hedge funds are large and sophisticated and have the capacity to analyze and endure the risk of investing in these funds, whereas the smaller public investor is less well-equipped to do so. On the other hand, one must question why the apparent advantages of hedge funds cited above should be denied the retail investor. As most of the blow-ups in hedge funds have come from the excessive use of leverage, it may be prudent to preclude retail investors from investing in highly leveraged funds.

I would now like to turn my attention to short selling and the important role I believe it plays in creating more liquid, balanced and fair markets. Short sellers already operate on a playing field tilted sharply against them, and considerable restrictions and risks relate specifically, and often uniquely, to this strategy. Unlike a long investor who can buy a stock at any price or repeatedly at ever

higher prices intraday, the short seller must initiate his or her position only on an "uptick" – a price above the immediately preceding trading price. In contrast to a long position, in which only the initial investment can be lost, there is a risk of potentially unlimited loss on a short position. The short seller is obligated to pay dividends to the holder from whom stock was borrowed and, most especially, there is the potential loss of one's ability to determine when the short position is purchased or covered. If the supply of borrowable stock dries up, the short seller may be involuntarily "bought in" by his broker in what is generally known as a "short squeeze." The short seller has no control over when the stock is bought in or the price at which it is executed. This situation is clearly distinct from that of the long holder who cannot be forced into an involuntary sale.

The contribution of the short seller to more efficient markets can be best evaluated in the context of the stock market of the last six years. An equity bubble of extraordinary proportions developed in the late 1990's peaking in early 2000. The internet mania was just the most visible part of the general hysteria. Since the peak, the bubble has deflated, costing investors some $7 trillion dollars.

The goal of regulatory policy must be to establish fair and safe markets for investors. In considering what, if any, regulatory changes are appropriate, I believe it important to reflect on the forces that created the bubble as well as those which have led to its demise. In that connection, it is important to understand the structural bullish bias in the market. Shareholders, of course, want their stocks rising. Corporate officers desire higher prices, as the price of their stock serves both as their report card and, thanks to the liberal use of options, the key to enormous personal wealth. Higher stock prices also provide inexpensive acquisition currency for acquisitive issuers. Security analysts clearly want stocks higher to validate their recommendations. There must be a seller for every buyer or no trades would occur. Thus, it is interesting to note that while 50% of stock transactions are, by definition, sales, purchase recommendations by analysts are 10-20 times more numerous than sale recommendations. The recent Wall Street settlement has focused on the pressure placed on analysts from internal investment banking, but pressures from clients and corporate executives have received much less attention. Analysts who recommend the sale of a stock risk the ire of their clients who own it. These clients complain to research directors and can withhold favorable votes in reviews important to analysts' compensation. Similarly, corporate executives frequently react in a hostile manner toward any analyst who downgrades their stock, restricting his or her contact within the company, thereby making future analysis of the company more difficult. Collectively, these factors, coupled with a cheerleading media, created the bubble. Anyone challenging the valuation of a company or the integrity of its financial statements was most unwelcome in this environment. Analysts and market strategists who either warned of overvaluation or were insufficiently bullish were pushed aside, replaced by those who went along with the irrational exuberance.

Short sellers, through their research and public skepticism, provide a much needed counterpoint to the bullish bias described above. They are willing to ask tough questions of managements in meetings and on conference calls, thereby providing a more balanced view for listeners. Investors benefit by getting both sides of the story when the views of short sellers appear in the media.[2] Short sellers have helped uncover many frauds and accounting abuses in recent years at Enron, TYCO, Conseco, AOL, Boston Chicken, Network Associates and Lernout & Hauspie, among a host of others. Short sellers frequently serve as unpaid, but self interested, detectives and have willingly shared their findings with the SEC, which has acknowledged the usefulness of these inputs. Although there have been occasional instances in which short sellers have been accused of circulating misleading stories, these instances are dwarfed both in number and magnitude by the misleading stories circulated by long holders and the issuers themselves. Because of the greater risks in short selling, research done by short sellers has tended to be more careful and accurate than most. As Gretchen Morgenson of *The New York Times* recently reported:

> If you own shares in a company that declares war on short sellers, there is only one thing to do: sell your stake. That's the message in a new study by Owen A. Lamont, associate professor of finance at the University of Chicago's graduate school of business... The study, which covers 1977 to 2002, shows not only that the stocks of companies who try to thwart short sellers are generally overpriced, but also that short sellers are often dead right.[3]

The value of short selling as a means for creating greater liquidity and orderly markets is well understood. Specialists on the major exchanges sell short to help offset an imbalance of buy orders. Trading desks at brokerage firms do so as well to facilitate customer orders. It is important to note that over two-thirds of short selling is related to arbitrage activity.

Any effort to further restrict short selling should be rejected. While short sellers seem to attract a disproportionate amount of attention, usually from companies with questionable accounting or business models who do not welcome scrutiny, the number of short biased firms are few in number and are actually shrinking. Many short sellers were driven out of business during the bubble and, even today, they represent the only subcategory of hedge funds that has seen net redemptions in recent years. Of nearly 6,000 hedge funds, short biased funds

---

[2] I wrote articles for *Barron's* "Other Voices" column during the bubble. The first in 1999, "A Crowded Trade," warned of the dangers following the large mutual funds' loading up on richly priced, large capitalization stocks. In 2000, "The Fed Should Act Now" urged the Fed to adopt more stringent margin policy in a clearly overheated market; and in 2001 I wrote "Fantasy Accounting" which identified how the failure to treat options as expenses led to a vast overstatement of corporate earnings. (Copies are included.)

[3] "If Short Sellers Take Heat, Maybe It's Time to Bail Out," Gretchen Morgenson, *The New York Times*, January 26, 2003.

with asset bases of $100 million or more number fewer than 10, and the total assets managed by these entities are well under 1% of the total assets managed by all hedge funds. That few managers have chosen this strategy or have been able to survive suggests that there are easier ways to make a living.

The short interest in each stock is reported monthly, yet there are proposals circulating, most visibly from the Full Disclosure Coalition now in formation by the Washington law firm, Patton Boggs, which would seek to have individual short sellers detail their short positions in periodic Schedule 13D and Form 13F filings. The claim being made is that this would level the playing field, but as shown earlier, the playing field is already tilted sharply against the short sellers. Such disclosure requirements would serve only to make targets of individual short sellers and likely drive them out of business. Some publications are designed specifically for the purpose of creating short squeezes which can be exploited by other aggressive hedge funds and mutual funds who know that short sellers cannot defend themselves by selling on down ticks.[4] Most companies simply ignore short sellers, recognizing that there are differences of opinion in free markets, and go about their business. In light of Mr. Lamont's findings, it will be interesting to see which companies will become part of this coalition.

The Williams Act requires the filing of a Schedule 13D or Schedule 13G to alert a company that someone is accumulating more than 5% of their shares. No such threat exists from a short position. A short sale does not make the short seller the owner of the security (in fact, it is the opposite) and does not result in any voting authority for the short seller.

Given the positive contribution by short sellers and the evident shrinkage in their number, consideration should be given to truly leveling the playing field by modifying the uptick rule. This would contribute to greater market stability in today's electronically driven securities markets.

Short selling is an important part of the public capital markets. Any further bias in favor of long investors will further erode the important counterweight short sellers provide to the market. Short selling is an important investment tool as part of a proper risk-reduction investment strategy. The marketplace not only understands the benefits of short selling; it in fact requires it.

Thank you for your time and attention.

[4] The ShortBuster Club formed by Sky Capital LLC™ and the Erlanger Squeeze Play. Examples attached.

OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

A Crowded Trade

These big-cap investors are complacent now, but when they break ranks . . .

BY DAVID ROCKER • A trading position is said to become "crowded" when it is held by a vast preponderance of investors. Such positions develop when investors become so convinced of the logic of the position and its likely success that they become complacent. Crowded trades are dangerous because if anything occurs to shake the faith of these investors, efforts to bail out can be highly disruptive; few others are left willing to take the other side.

The convergence trades held by Long-Term Capital Management and the proprietary desks of many brokerage firms last fall, in which participants shorted Treasuries and purchased lesser-quality bonds in the expectation that spreads between the two would narrow, are examples of such trades and the violence that comes with unwinding them. Another recent example was the Japanese carry trade in 1994, when long U.S. bond positions were financed by banks and hedge funds borrowing cheaply in Japanese yen. The current investor infatuation with large-capitalization U.S. equities may be the most crowded trade ever.

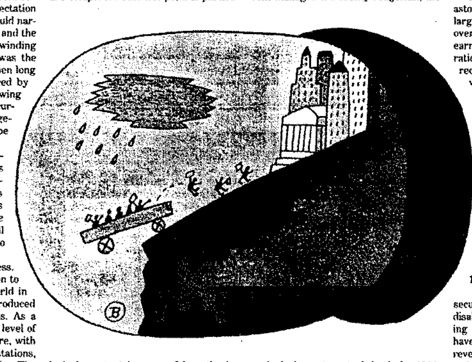
The development of a two-tiered market in which investors focus on a relatively small number of high-capitalization stocks to the exclusion of most others has been amply discussed in the media. What has been less well discussed is how this has come to pass.

Nothing succeeds like success. The U.S. stock market has proven to be the eighth wonder of the world in the past decade as it has produced steady outsized financial returns. As a result, the market has risen to a level of unusual prominence in our culture, with tickers now scrolling in train stations, restaurants and even tennis clubs. The investing public, having been told endlessly that equities have far outperformed bonds and other more liquid investments, now assumes that such trends may be safely extended into the future. Indeed, there has become almost a sense of entitlement to 20% annual returns in an economy growing at 3%.

Investors have become reactive rather than anticipatory. Mutual-fund purchases accelerate after market advances and diminish or turn to liquidations after declines. The rise of momentum investing has reinforced this buy-high, sell-low mentality. A nation that reveres Warren Buffett has essentially disavowed his investment style to chase expensive stocks.

DAVID ROCKER is a general partner of the hedge fund Rocker Partners L.P.

The affection for large-capitalization stocks as a subset of the overall market stems from their recognizable names and products, the relative ease of trading them and their presence in the indexes against which money managers are compared. This last point is particularly important because of how the investment-management industry itself has changed in recent years.



No professional (I use this title loosely) is measured more than a portfolio manager. No one hires two lawyers or accountants, gives them the same problem, and then compares how each produces and bills for services. Yet this is commonplace among money managers. Net asset values are recorded daily in newspapers, and consultants regularly monitor results for nonpublic funds. These results are readily compared with the Dow Jones or Standard & Poor's 500 averages.

Because markets have risen so persistently in the past decade, evaluations have focused on relative, rather than absolute performance. Managers know that while investors usually talk about long-term results, they pick managers largely based on short-term relative performance. One must keep up with the averages or lose assets under management.

This point was publicly driven home by the experience of Jeff Vinik, the portfolio manager of **Fidelity Magellan**, the nation's largest mutual fund. In 1996, Vinik sold stocks to position his portfolio more conservatively. The market, however, continued to advance, and Magellan underperformed. Vinik was driven from Fidelity despite his attractive long-term record. Underperformance for even a short period couldn't be tolerated.

Other portfolio managers, strategists, consultants and plan sponsors got the message: "The standing nail gets hammered." Since then, they have chosen to be more fully invested and to more closely align their portfolios with major market averages. This, of course, has increased demand for the stocks within the averages over those not in the averages. But the action of investors trying to match the averages created an effect similar to a swimmer trying to grab a large beach ball in a pool. The more aggressively he swims toward the ball, the more surely it floats away.

By their efforts to emulate the indexes, managers have created a situation in which the indexes have outperformed more than 90% of active portfolio managers. This result has fostered increased preference among investors for index funds over active managers, further heightening demand for the large-cap stocks in the indexes. Witness how any stock added to a key index spikes sharply higher for that reason alone. The cycle is self-reinforcing.

This trend has produced some rather astonishingly high valuations. The 100 largest stocks on Nasdaq now sell for over 100 times their trailing 12-month earnings. Similarly, the price/earnings ratio of the Standard & Poor's 500 is at a record high. Normally, such elevated valuations would put off investors and encourage them to seek cheaper alternatives, but disregard for absolute price as an investment consideration has become a hallmark of the current market.

The talking heads seen regularly on television and in other media have justified their continued purchase of these expensive stocks by saying that if one buys good stocks and holds them a long time, they will grow into their valuations. This philosophy may sound familiar to those who remember the Nifty Fifty era of 1973-74.

Changes in the job function of securities analysts over the years have disabled another normally self-correcting mechanism. As commission rates have contracted, investment-banking revenue has become far more important to brokerage firms, and analysts' compensation packages have been altered accordingly. Analysts now are actively engaged in trying to bring investment-banking business to their firms. Recommending the sale of an overpriced stock is not the best way to gain the favor of chief executives. Analytical independence has been compromised as a result. Indeed, analysts generally have been more like cheerleaders, constantly "reiterating their buy recommendations" at ever higher prices to endear themselves to options-laden managements. In post-earnings conference calls, many questions are cloyingly prefaced by phrases like "Great quarter, John."

Corporate officers, in concert with their investment bankers and accountants, have encouraged acceptance of these large stocks' high valuations. With the blessing of the analytical community,

January 10, 2000 BARRON'S

OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

The Fed Should Act Now

It has let market speculation get out of hand

BY DAVID ROCKER • The health and vitality of the U.S. economy have become dependent on a robust stock market. In an important speech at Jackson Hole, Wyoming, several months ago, Alan Greenspan indicated that the Fed is now sensitive to the potential for the stock market itself to cause an inflationary overheating of the economy. Based on the Fed's own model — even after last week's selloff — the market has never been as expensive as it is now. Not in 1929, not in 1987, never.

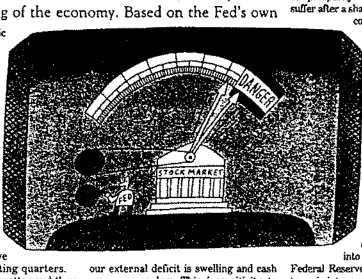
Much of the market's inexorable rise stems from the democratization of investing. CNBC, Bloomberg and CNN, among others, pour out a steady stream of stock-market information to homes, airports, bars and even the sides of buildings. The American people have gotten the message. Never before have so many invested so heavily, confident that the market cannot go down for any sustained period.

Investors have become increasingly complacent because there have been so few meaningful declines over the past two decades and markets have snapped back quickly from those setbacks. The assumption that past trends will persist, the essential analytical basis for the Dow 36,000 theorists, is a dangerous one. Long-Term Capital Management regularly earned nearly 40% a year. On that basis, one might have extrapolated a similar growth rate in 1998 with little volatility. They lost 90% of their capital in a month.

In the current feverish environment, it may be helpful to reflect on some traditional verities.

First, price matters in making an investment decision. While the Mercedes is a good car, it is probably not a sensible purchase at $500,000. While earnings of U.S. stocks have grown over the past decade, that growth rate has been unexceptional and P/Es have never been this high, even during periods of lower inflation and faster earnings growth.

Second, reported earnings are of sufficiently low quality that the Securities and Exchange Commission has become more vocal on this issue. Chief financial officers seem to have had at least as much to do with reported profit gains in recent years as chief operating officers. Corporations have been telling their shareholders a story far more optimistic than the one they're telling the tax collector. Federal corporate tax receipts were actually lower in 1999 than in 1998 and the Congressional Budget Office expects another decline this year. Investors have been piling into technology stocks to the exclusion of others because of their supposedly brighter earnings prospects, yet Dell, Intel, IBM, Hewlett-Packard, Lexmark and Xerox, among others, have recently had disappointing quarters.



Third, interest rates matter and they have been rising significantly around the world. Stocks have soared even though yields on long U.S. Treasury bonds have risen nearly 30% over the past year. Internet and other high-P/E stocks, which logically should have been the most adversely affected by rising rates because their multiples are high and their payouts more distant, have risen the fastest in this twilight zone of a stock market.

Fourth, as Long-Term Capital Management showed, leverage increases volatility. Investors have dramatically increased their leverage to maximize returns. Margin loans have risen vertically in the past several years to record levels. While it is not easily measured, it is also clear that large sums have been borrowed against homes and credit cards for stock purchases. Similarly, percentage cash reserves at mutual funds have been drawn down almost to all-time lows. Everyone owns the same small group of large-capitalization technology stocks. Investors are behaving like sheep on margin. The American public has committed the greatest percentage of its assets to the most expensive stock market in history at a time when the Federal Reserve is overtly tightening, our external deficit is swelling and cash reserves are low. This insensitivity to risk is dangerous.

The Federal Reserve and other government agencies have been significantly responsible for this euphoria because of the asymmetry of their policies. The Fed argues that markets should be free of government intervention; but it seems that such views are espoused only so long as markets are rising. When the market crashed in 1987, the Fed intervened. When banks and savings and loans were bankrolling wildly risky deals, the government looked on and did nothing. When this recklessness produced vast losses, the government stepped in to bail out the speculators — at enormous public expense. When LTCM overleveraged itself, regulators sat idly by. When its collapse in 1998 led to a market decline, the Fed stepped in again to coordinate the bailout, cut interest rates and pump in money. Once again, the government stopped natural corrective forces from punishing speculators, as always cloaking its actions in the mantle of the national interest. The message to the investing public has been clear: "The government will protect you from the downside but will not restrain your upside." Why not speculate?

As the "buy the dip" mentality is now so fully ingrained as to prevent all but a sudden steep decline, the risk has risen that this market will end violently, threatening our prosperity. The economy would clearly suffer after a sharp selloff because so many consumers are now so heavily invested. Real-estate values would fall. With U.S. equities out of favor, the demand for dollars would shrink, forcing the U.S. to pay higher interest rates to attract foreign capital to cover our rising trade deficit. The combination of a weaker economy and rising interest rates would further depress the stock market. In essence, the whole positive cycle we have enjoyed in the past decade would be thrown into reverse. Of course, the Federal Reserve would then be expected to again intervene.

Fed officials have periodically expressed concern about market valuations and speculation, but then the governors reverse themselves with "new paradigm" speeches and commitments not to raise margin requirements. Each reversal has brought forth a new burst of unbridled investor enthusiasm. The 100 largest Nasdaq stocks rose 102% last year and are selling at over 130 times earnings. The IPO market has been on steroids. In a testament to these times, one magazine implicitly criticized Warren Buffett, who has made nothing but money, while another lionized Jeff Bezos of Amazon.com, which has lost ever-increasing amounts of money.

If the Fed is serious, it should send an unambiguous message to investors that excessive speculation is unwelcome. It should raise margin requirements and interest rates immediately with a clear warning that more increases will come in the future if this speculation persists. It is better to accept moderate pain now and reintroduce a sense of risk to the marketplace than to wait until a massive blowoff and subsequent collapse occur that could severely damage this nation for years. ■

DAVID ROCKER is general partner of Rocker Partners.

OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

Fantasy Accounting

New financial reporting standards distort reality

BY DAVID ROCKER • As a portfolio manager, I need financial reports that accurately reflect the financial health and progress of the companies I seek to analyze. Unfortunately, recent decisions by the Financial Accounting Standards Board are not helpful and go so far as to defy common sense. These decisions have related to both employee stock options and goodwill. While the FASB doesn't consider options to employees to be compensation, everyone else does. Employees do and are willing to work for less cash than they would without them. Corporations recognize them as compensation as well. When share prices fall, some lower the prices of options previously granted, while others raise salaries to offset their employees' paper losses. As Warren Buffett put it, "If options aren't compensation, what are they?"

The IRS treats options as a compensation expense for tax purposes. When an employee exercises an option to buy shares at \$20 when the stock's at \$50, he must report taxable income of \$30, and the IRS deems that the issuer incurred an equal expense. Such credits are frequently some of the largest items on corporate cash flow statements. For the five companies in the table, they represented an average 67% of earnings and 57% of the operating cash flow for the periods shown.

If the IRS allows these deductions because they are deemed legitimate business expenses, it is difficult to understand how the FASB can promulgate a reporting standard that disregards them.

The usual excuse given for not treating options as an expense relates to the indeterminancy of their use: What value do options have if they are never exercised? This is neither relevant nor insurmountable. Fischer Black and Myron Scholes received a Nobel Prize for developing a pricing model for options. Complex valuation issues may remain, but clearly options have significant measurable value. The charge to the income statement for an employee who receives \$150,000 in dollars and \$50,000 in British pounds is \$200,000. However, as a result of the FASB position, if that same man is paid \$150,000 in dollars and \$50,000 worth of options, the income statement would be charged only \$150,000.

Recently, the FASB has required footnotes in annual reports showing the financial impact of options. This leaves inflated earnings in the regular profit and loss statement compared with a more realistic standard that would include the cost of options. This, in turn, makes price/earnings ratios appear lower than they would be otherwise. As a result, heavy option-issuers appear cheaper to investors than those that pay their employees primarily in cash.

FASB's position on options makes life easier for investment bankers, who raise enormous sums for heavy option issuers. Could so much money have been raised for Internet startups and roll-up acquisition companies if analysts at investment banks had been required to include options expense in their financial models supporting the public offerings? This overstatement of earnings has contributed to a significant misallocation of resources within the economy, and to the losses suffered by investors.

The FASB has also been concerned about the distortive effects of "dirty pooling" and recently issued an exposure draft which would lead to its elimination. Unfortunately, the proposed cure is worse than the disease. Acquiring companies would have to use purchase accounting, which has historically required an annual amortization expense that gradually writes down goodwill, the premium paid over book value. The FASB's new purchase accounting proposal would eliminate all amortization expense. Goodwill would be shown as an asset but would never be amortized unless the company itself found it to be "impaired." This is like putting the fox in charge of the chicken coop.

Companies are frequently valued in the stock market at greater than their stated net worth because their research and development spending is expected to produce products of value, or because of valuable brands created through advertising. Research and development costs and advertising budgets are expensed annually. When companies with these attributes are acquired, the value of these prior expenditures is capitalized to goodwill, which, unlike plant and equipment, would not be depreciated.

The FASB proposal will aid managements inclined to inflate reported earnings. A public company could boost reported profits by transferring scientists to a new private company and then acquiring it after their research led to development of new products. Research thus wouldn't show up as an expense on the public company's books. Similar arrangements could enhance revenues.

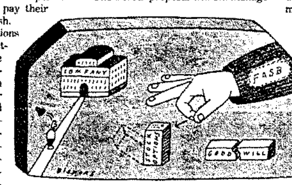
As was the case with options, the FASB seems to have taken the position that, because there is difficulty deciding the appropriate amount of expense to be taken, no expense whatsoever should be recorded. Today companies are acquired because of their talent, technology and market positions, among other reasons. The value of these intangible assets change over time. Good people leave, products become obsolete, and competitors gain market share. If anything, accelerating technological change demands shortening amortization periods rather than eliminating them.

Most of the tests to be used in determining when impairment occurs are backward-looking, such as when the share price has fallen below book value. Such a declaration of impairment won't assist investors. It will be as useless as an analyst downgrading a stock at \$5 that he recommended for purchase at \$50, and it will be as common. Impairments will be run through the income statement in large lump sums, encouraging analysts to ignore them as both extraordinary events and non-cash charges. Analysts who like to talk about cash earnings somehow never seem to consider the initial outlay for an acquisition to be a cash charge.

It's bad enough that the FASB allows corporations to tout customized "pro forma" earnings. For example, Amazon.com excludes amortization of goodwill and intangibles, its share of losses in partially owned companies, merger and acquisition costs, and stock-based compensation. Others choose their own menu. Thanks to FASB's tolerance of such shenanigans, companies are being evaluated by different self-defined earnings standards. If the goodwill proposal is adopted, there will be a huge increase in acquisitions, and even more unexplained variance among corporate reports.

The final positions on both options and goodwill accounting are vastly different than the FASB's initial proposals. The FASB has simply caved in to extensive and persistent lobbying by corporations and investment bankers that would benefit from such weakened standards.

The U.S. has held up its accounting as a model for the rest of the world, claiming that accuracy and rigorous regulation have made our markets the safest, broadest and most efficient in the world. If the FASB has come to stand for Fantasy Accounting Serving Business, our accounting will be unworthy of emulation. ■



Profit Boosters

▶ *The tax benefits that flow to companies from employee stock plans have had a powerful effect in improving the reported earnings of some top high-tech companies.*

	Sun Microsys (3 mos. Oct)	Microsoft (3 mos. Sept)	Intel (9 mos. Sept)	Cisco (3 mos. Sept)	Dell (9 mos. Oct)
Tax Benefit from Employee Stock Plan* (Most Recent Operating period)	\$472	\$1,215	\$852	\$985	\$739
Earnings*	\$510	\$2,191	\$8,342	\$798	\$1,802
Tax Benefit as Percentage of Earnings	108%	55%	10%	123%	41%
Operating Cash Flow*	\$701	\$2,857	\$1,107	\$1,363	\$2,993
Tax Benefit as Percentage of Operating Cash Flow	67%	43%	77%	72%	25%

*In \$millions

Source: Company reports

Maris Bishofs for Barron's

DAVID ROCKER is a partner in Rocker Partners, an investment management firm in New York.

Barron's welcomes submissions to "Other Voices". Essays should be about 1,200 words in length, and sent by e-mail to the Editorial Page editor at tg.donlan@barrons.com.

they have persuaded investors to focus on "operating earnings" rather than "reported earnings," which are frequently encumbered by writeoffs and special charges. According to estimates by Goldman Sachs, reported earnings for the S&P 500 showed no growth at all from 1996-1998. Only by adding back unusual charges, which rose 170% during this period, was there any growth in "operating earnings."

The media have also played an important part in encouraging acceptance of high valuations. Money managers, analysts and corporate executives regularly appear on television to expound the virtues of their favorite stocks, but valuations are rarely discussed, and commentators rarely challenge their interviewees on this subject. This bias of the media is readily evident by the recent brouhaha at CNBC when James Cramer indicated he thought a stock overvalued and considered shorting it. The company involved threatened a lawsuit and Cramer, a frequent guest, was temporarily blocked from further appearances. Apparently, it is perfectly acceptable for dozens of portfolio managers and corporate officers to push their stocks, but contrary viewpoints seem less welcome.

The insensitivity to price has even spread to the public sector. When Alan Greenspan expressed his concern about "irrational exuberance" at 6300 on the Dow, he received so much criticism that even though prices have risen another 50% from those levels, he now speaks in highly subjective tones as to whether the market may be overvalued. While it may have been prudent for the Fed to help orchestrate the bailout of Long-Term Capital Management, which had leveraged itself 100 times, the action served to intensify the very speculative fervor that had apparently worried the Fed earlier. Investors, convinced that the Fed would support the market at all costs, developed a casino mentality that pushed Nasdaq up 70% from its October lows. Online trading exploded and Internet stocks soared to unimaginable levels without any cautionary comment or act of restraint from the Fed.

The dominance of the high-cap stocks has persisted for so long that skeptics have capitulated or been run over. Value managers have watched their assets drain away to large-cap managers. Even short sellers have largely given up. The short interest in **Dell** was 116 million shares in October when the stock sold at $25. Now, with the stock at $43 and with indications of a marked slowdown in growth, the short position is only 48 million.

Everyone is on the same side of the boat. The complacent response has been: "One could have made much the same argument last year, but the stocks are now much higher. What is going to change?" Such passionately held beliefs die hard, but every previous crowded trade has ultimately ended unhappily, usually for reasons that were unanticipated.

Crowded trades begin to unwind when some participants become concerned, break ranks and sell their positions, fearing that they must act before others do. The subsequent underperformance then challenges the confidence of others who have held the same positions only because the strategy was working. As more investors try to leave at the same time, things deteriorate quickly. Prices drop sharply because, in their hearts, everyone knows the positions to be overvalued. The collapse of Japanese long-bond prices as rates moved up sharply is a recent example. The daisy chain is only as strong as its weakest link.

The rise of momentum investing has reinforced a buy-high, sell-low mentality. A nation that reveres Warren Buffett has essentially disavowed his investment style to chase expensive stocks.

There are some challenges ahead for the new Nifty Fifty. The Securities and Exchange Commission finally seems to be getting serious about stopping accounting practices that artificially inflate or manage earnings. As these practices are eliminated, earnings surprises will become more numerous and the illusion of consistency that has led investors to pay big premiums for predictability will disappear. Additionally, the rise in long-term interest rates we have just experienced makes high multiples more vulnerable. Trade conflicts among nations are becoming more numerous, and these have triggered financial crises in the past. It would not be shocking to see the big-cap names trade substantially lower now that their invincibility has been so broadly accepted. After all, this is what happens in all crowded trades. ■

SHORTBUSTER CLUB
SKY CAPITAL LLC™

The "ShortBuster Club"

The "ShortBuster Club" ™ presents a monthly table listing 100 heavily shorted NYSE and ASE stocks. Some of these stocks appear to have substantial upside potential based upon the fundamentals as reported by the individual companies and the possibility that short covering could accelerate an upward movement in the stocks' prices.

At least 10% of the shares outstanding have been shorted in 80 of these stocks, and in 93 of them the number of shares short equals more than 10 days of average daily trading volume for the month ended April 15, 2003. (Source- Bloomberg, Reuters).

The table for each company lists the Price/Earnings Ratio based on earnings estimated for 2003, an estimated three-year growth rate, the recent market capitalization, and the percentage of shares outstanding held by institutions.

A guide to the intensity of the short interest in each stock is provided in the columns on the right under the headings DTC (Days to Cover), SSH (Shares Short as a Percentage of the Shares Outstanding), and SX (Spark Index), which is the sum of DTC and SSH. For the ShortBuster Club, SX provides a guide to the intensity of the short interest.

Sky Capital LLC currently has a Strong Buy rating on Fremont General (FMT) and Vector Group (VGR). Please contact Ray Dirks for information on these 2 stocks including copies of research reports written by Theodore Kovaleff and Stevens Monte respectively.

In a few days, The Shortbuster Club will provide a similar table for heavily shorted stocks listed on NASDAQ.

The ShortBuster Club will provide this table once a month before the end of the month. Additional information is available on an interim basis by contacting Ray Dirks at: (212) 709-1939, or toll-free at: (866) 991-9918, or by fax at: (212) 709-1950, or by e-mail to tkovaleff@skycapitalllc.com.

Table 1: Heavily Shorted Stocks

SYM	NAME	Price 5/2/03	P/E est. 2003	Price/ Book	Gth (3 yr)	MKT cap ($000,000)	Institutional % Ownership	DTC (Days to Cover) Nov	Dec	Jan	Feb	Mar	Apr	SSH (% Outs)	SX Spark (index)
PPD	Pre-Paid Legal	24	12	15	10	422	61	28	16	15	23	29	53	53	106
SWS	SWS Group	17	20	1.1	10	284	70	87	101	44	55	39	66	21	87
USG	USG	7	3	0.5	10	317	47	59	42	36	39	27	59	22	81
SRZ	Sunrise Assisted Living	28	10	1.2	13	618	83	38	33	24	35	54	26	25	80
IFC	Irwin Financial	24	11	1.8	14	657	42	37	69	41	58	75	56	14	70
SFP	Salton	13	6	0.5	8	145	42	42	52	35	35	64	56	14	70
TRN	Trinity Industries	17	17	0.8	10	780	94	36	54	48	71	80	46	22	68
ATN	Action Performance	19	10	1.4	16	334	39	8	11	24	18	31	28	39	67
ASF	Administaff	7	21	1.7	25	193	83	17	22	26	31	28	40	24	64
MSV	Manufacturers Services	4	21	1.3	19	144	93	32	24	33	48	60	56	7	63
AGM	Federal Agricultural Mortgage	23	11	1.8	20	261	77	36	70	25	17	45	44	18	62
TRR	TRC Cos.	12	10	1.2	30	156	41	11	14	20	31	41	19	60	60
IDN	Intelli-Check	7	Loss	17	10	66	4	38	14	33	45	76	46	14	60
PLB	American Italian Pasta	43	17	3	15	753	124	13	24	32	21	27	27	31	58
COA	Coachmen Industries	13	16	1	10	203	80	57	53	29	19	48	49	8	57
PQE	ProQuest	24	13	5	17	673	105	6	15	11	16	18	32	24	56
FLE	Fleetwood Enterprises	6	LOSS	1.3	10	217	133	57	37	46	21	33	27	28	55
AND	Andrea Electronics	0.2	LOSS	0.3	10	5	11	27	8	24	43	49	49	6	55
RHB	Rehab Care Group	17	10	1.5	19	293	110	21	32	35	24	42	36	18	54
ION	Ionics	19	40	0.8	13	340	84	13	23	34	33	32	23	30	53
COO	Cooper Cos.	28	13	3	21	864	114	13	27	12	18	18	21	31	52
MSS	Measurement Specialties	4	5	2	20	48	29	20	23	43	47	40	40	11	51
XLA	Xcelera	0.9	Loss	0.8	10	106	1	8	12	16	19	38	50	1	51
BFT	Bally Total Fitness	6	4	0.4	13	215	87	22	30	17	24	20	23	27	50
DRD	Duane Reade	14	11	1	20	326	130	14	27	19	9	15	28	21	49
ALD	Allied Capital	21	12	1.5	7	2,397	42	41	35	43	37	28	32	17	49
SEN	SEMCO Energy	5	10	0.9	3	101	18	26	25	26	17	27	36	12	48
CRY	CryoLife	8	LOSS	2	20	162	40	9	11	13	14	7	22	26	48
NOR	Northwestern Corp.	2	4	0.2	10	91	53	20	31	14	24	21	18	28	46
AIR	AAR Corp	4	Loss	0.4	10	130	93	11	31	16	26	20	42	4	46
OCA	Orthodontic Centers of America	6	5	0.7	12	304	90	14	17	26	29	44	13	32	45
VGR	Vector Group	12	10	20	25	431	39	20	31	51	42	53	34	11	45
CHS	Chico's FAS	24	24	8	24	2,054	94	15	18	18	17	14	18	26	44
FTS	Footstar	10	5	0.7	14	195	119	18	13	21	11	24	19	25	44
COB	Columbia Laboratories	5	LOSS	NEG	10	189	33	11	27	21	31	38	38	5	43
NLS	Nautilus Group	13	8	2	16	434	41	8	24	24	17	33	12	30	42
MWY	Midway Games	3	15	0.9	20	150	54	12	9	10	22	28	28	13	41
GAP	The Great Atlantic & Pacific Tea Co.	6	LOSS	0.5	10	240	-	8	9	13	11	23	33	8	41
MFC	Manulife Financial	26	11	1	14	12,155	27	29	31	40	49	58	39	2	41
FS	Four Seasons Hotels	32	45	1	10	1,119	53	9	15	14	13	20	17	22	39
MMS	Maximus	24	14	1.7	13	506	105	21	23	26	28	30	20	19	39
AM	American Greetings	15	11	0.9	8	971	144	26	23	29	18	22	20	19	39
PII	Polaris Industries	57	13	5	14	1,255	76	7	12	9	9	12	15	23	38
KKD	Krispy Kreme	32	41	7	30	1,846	53	19	12	14	12	15	16	22	38
SKO	Shopko Stores	12	8	0.6	13	357	107	16	9	20	20	18	20	20	38
UVN	Univision	30	60	4	26	6,845	74	14	24	25	33	31	9	28	37
MXT	Metris Companies	3	LOSS	0.3	16	197	95	16	17	12	6	23	9	28	37
NFI	NovaStar Financial	45	6	2	15	441	67	12	29	6	7	12	14	22	36
ELY	Callaway Golf	14	15	1.6	10	1,079	83	19	22	16	17	29	22	14	36
CPN	Calpine	5	12	0.5	10	1,974	59	8	10	14	14	17	12	23	35

**Statistical source of information above- Bloomberg, Reuters.

PXP	Plains Exploration	9	5	1.2	10	207	57	-	-	1	7	14	27	8	35
BHE	Benchmark Electronics	26	14	1.3	19	644	108	13	11	12	12	13	11	23	34
CUM	Cummins Inc	28	34	1.4	8	1,090	83	8	11	15	12	16	11	22	34
GMT	GATX	18	14	1.1	12	905	94	21	17	19	12	17	18	16	34
MCL	Moore Corp.	11	14	3	12	1,263	72	1	0	2	9	19	21	13	34
HAE	Haemonetic	18	16	2	14	428	105	14	16	18	22	31	25	9	34
MPH	Championship Auto	4	Loss	0.5	10	53	47	5	10	5	13	24	24	9	33
GEG	Global Power Equipment	6	17	2	15	263	60	17	16	29	48	65	29	4	33
JAH	Jarden Corp.	30	11	5	11	426	76	3	5	10	13	14	17	15	32
FMT	Fremont General	10	6	1.7	25	754	-	24	35	41	59	16	19	13	32
CHB	Champion Enterprises	2	LOSS	3	15	135	87	28	21	34	57	63	20	12	32
FWC	Foster Wheeler	3	5	NEG	13	110	27	51	30	29	30	45	21	11	32
SM	St. Mary's Land & Exploration	27	11	2	10	840	68	15	16	15	21	22	25	7	32
MNS	MSC. Software	6	13	0.8	20	188	71	13	13	18	24	23	26	6	32
AMR	AMR Corporation	5	LOSS	0.9	7	855	75	5	4	6	6	11	3	28	31
ACV	Alberto Culver	49	19	3	11	2,843	38	18	18	20	17	26	21	10	31
WGO	Winnebago Industries	39	13	4	17	706	68	7	11	9	11	13	8	22	30
GT	Goodyear Tire & Rubber	6	LOSS	2	5	1,113	59	10	10	12	7	17	13	17	30
TSS	Total System Services	19	27	6	15	3,740	7	27	37	36	40	31	27	3	30
ACF	AmeriCredit	7	13	0.6	17	1,060	116	14	15	16	4	8	9	20	29
MRX	Medicis Pharmaceutical	59	26	4	17	1,587	-	12	16	16	10	15	12	17	29
CVC	Cablevision Systems	22	LOSS	NEG	13	6,304	69	10	14	16	13	17	16	13	29
ORB	Orbital Sciences	6	17	1.9	13	262	59	9	12	20	10	14	16	13	29
PNX	Phoenix Companies	8	14	0.4	15	752	-	2	5	3	13	26	22	7	29
STN	Station Casinos	22	20	5	15	1,234	79	13	19	23	18	17	14	14	28
FCN	FTI Consulting	47	18	3	21	1,279	89	12	13	20	12	17	14	14	28
AMT	American Tower	7	LOSS	0.8	22	1,439	74	14	9	25	11	18	16	12	28
GPI	Group 1 Automotive	29	9	1.5	17	652	64	4	6	8	11	10	18	10	28
WIN	Winn - Dixie Stores	13	9	1.8	12	1,797	33	14	17	12	16	23	19	9	28
SOV	Sovereign Bancorporation	15	11	1.4	11	4,052	70	13	22	17	13	17	21	7	28
TE	TECO Energy	11	9	0.7	5	1,911	44	3	11	12	10	11	11	16	27
WMS	WMS Industries	14	60	1.8	18	435	62	14	15	11	12	15	20	7	27
HCR	Manor Care	20	14	1.8	13	1,786	94	7	13	19	11	18	16	10	26
MSO	Martha Stewart Living	8	70	1.7	17	450	19	14	8	19	14	14	21	5	26
NAV	NaviStar	28	LOSS	7	9	1,913	106	6	8	9	15	12	10	15	25
PCS	Sprint (PCS Group)	4	LOSS	12	22	3,702	-	13	11	14	13	22	15	10	25
LRW	Labor Ready	6	20	2	30	258	78	22	27	17	20	22	17	8	25
XRX	Xerox	10	18	4	9	7,416	-	17	18	20	13	17	17	8	25
UAG	United Auto Group	17	9	1	16	700	81	8	12	11	12	15	18	7	25
SIE	Sierra Health Services	17	8	3	15	473	71	1	1	2	2	5	11	13	24
MTG	MGIC	47	8	1.3	12	4,642	104	5	6	9	12	11	12	24	24
GGP	General Growth Properties	56	17	3	10	3,533	92	19	18	12	16	24	15	8	23
OMI	Owens & Minor	19	13	2	13	630	94	26	27	22	24	21	15	8	23
TEX	Terex	18	11	1.1	13	860	81	4	7	8	9	17	15	8	23
GY	Gencorp	8	17	0.9	10	331	85	12	8	13	12	12	16	7	23
SFN	Spherion	5	LOSS	0.7	12	284	91	16	20	13	17	20	19	4	23
CMO	Capstead Mortgage	11	5	1.3	10	157	15	10	1	4	6	19	9	13	22
ENZ	EnzoBiochem	16	45	4	20	450	27	14	19	18	18	24	16	5	21
RMD	ResMed	38	29	5	21	1,240	41	10	17	19	11	13	12	9	21
NDC	NDC Health	20	15	2	14	697	101	8	17	13	16	26	6	13	19

**Statistical source of information above- Bloomberg, Reuters.

[1]Sky Capital LLC prepared the information in this report and all opinions are those of Sky Capital LLC.

This report is based upon information available to the public. The information herein is believed by Sky Capital LLC to be reliable and has been obtained from sources believed to be reliable, but Sky Capital LLC makes no representation as to the accuracy or completeness of such information.

Opinions, estimates and projections in this report constitute the current judgment of the author as of the date of this report. They are subject to change without notice. Sky Capital LLC has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate

or misleading. This report is provided for information purposes only. In is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation would violate applicable laws or regulations.

Sky Capital LLC may be market makers or specialists in, act as advisers or lenders to, have positions in and effect transactions in securities of companies mentioned herein a principal or agency basis and also may provide, may have provided, or may seek to provide investment banking services for those companies.

Member NASD, SIPC

LOCATIONS

- **Sky Capital LLC**
  110 Wall Street, 8th fl
  New York, NY 10005
  Office 212·709·1900
  Facsimile 212·709·1950
  Toll Free 866·991·9918

- **Internet Address**
  www.skycapitalholdings.com

erlanger squeeze play

HOME LOGIN UPDATE ACCOUNT CONTACT US ABOUT PHIL ERLANGER PERFORMANCE OUR PHILOSOPHY HELP

Subscribe

VIEW THE LATEST...

- Newsletter
- Squeeze Alert
- Squeezeometer
- Squeezeometer Historical Data
- ESP Update
- Model Portfolio
- Type 1 Short Squeezes
- Type 4 Long Squeezes

MONTHLY NEWSLETTER

#022, April, 2003

DAILY SQUEEZEOMETER UPDATES

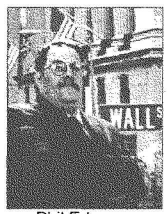
May 20, 2003

SQUEEZE ALERTS

#090, May 14, 2003

SPECIAL REPORTS

Welcome To *Erlanger Squeeze Play*



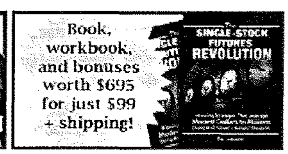
Phil Erlanger

Erlanger Squeeze Play is a unique service that provides a disciplined way to capitalize on recurring market phenomena. Through quantitative monitoring of price action and sentiment, we identify short-term trading opportunities in both long and short squeeze plays. At the same time, our analysis allows us to recognize the strength of an existing market trend and accurately classify any given stock as Buy, Sell, Hold or Sell Short.

WHAT IS A →SQUEEZEOMETER← click here to find out

This is the first time the investing public has had direct access to the Erlanger Factor. This indicator uncovers the individual issues, industry groups and sectors that put the odds in favor of individual investors and delivers incredible investment opportunities month after month.

We are committed to providing tremendous value through our research. It is with great pleasure that I invite you to become a charter subscriber.



MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT
OF
MANAGED FUNDS ASSOCIATION

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
OF THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

May 22, 2003

2025 M STREET, NW, SUITE 800, WASHINGTON, DC 20036, 202.367.1140, FAX: 202.367.2140
WWW.MFAINFO.ORG

WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION FOR THE HEARING:

"THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK"

May 22, 2003

INTRODUCTION

Managed Funds Association (MFA) is pleased to provide the following written statement in connection with the hearing of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises entitled "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk" to be held May 22, 2003 (the "Hearing"). This statement substantially incorporates the comments MFA submitted in connection with its participation in the Roundtable on Hedge Funds held by the U.S. Securities and Exchange Commission ("SEC") on May 14 and 15.

Mr. Chairman, MFA first would like to commend you for holding this most important hearing.

Today's Challenge for the Hedge Fund Industry. MFA believes that the hedge fund industry and public policy makers currently face an important challenge: preserving the recognized benefits that hedge funds bring to the global financial markets and the investment community as a whole while addressing legitimate investor protection issues that may be presented by the increasing interest of a broader range of investors in hedge fund investments. In this statement, MFA identifies the principal issues that it believes must be adequately considered in formulating a response to this challenge. This statement will also address related concerns that have been raised recently in regard to hedge funds and explore how they may be addressed as part of this response.

About MFA. MFA has more than 600 members who manage a significant portion of the estimated $600 billion invested in hedge fund products globally. Since its inception in 1991, MFA has provided leadership to the hedge fund and managed funds industries in government relations, communications, media relations and education for members and

investors. For example, MFA recently published *Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs* (2002) in response to the enactment of the USA PATRIOT Act.[1] MFA also maintains a library of hedge fund industry materials, many of which are accessible on its web site at **www.mfainfo.org**. These materials include government reports on hedge funds, Congressional testimony and speeches by regulators regarding hedge funds, legislation and rules relevant to hedge funds, as well as academic and industry papers and reports on hedge funds.

UNDERSTANDING HEDGE FUNDS

Hedge Funds Defined. Recognizing that there is no statutory or legal definition of a hedge fund, the President's Working Group on Financial Markets broadly defined a hedge fund as follows:

> "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[2]

Given the broad scope of the definition, it is not surprising that the term "hedge fund" captures "a wide range of investment vehicles, which can vary substantially in terms of size, strategy, business model and organizational structure, among other characteristics."[3] Although the word "hedge" refers to a hedge fund's ability to hedge the value of the assets it holds (e.g., through the use of options or the simultaneous use of long and short positions), some hedge funds engage only in simple "buy and hold" equity strategies or other strategies that do not involve hedging or arbitrage. In fact, the term "hedge fund" is used to refer to private funds engaging in over 25 different types of investment strategies, as discussed below.

---

[1] For a comprehensive view of MFA and its activities, please see the "Government Affairs" section of MFA's web site at ***www.mfainfo.org***.

[2] President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, April 1999 ("PWG Report"), at 1.

[3] *Sound Practices for Hedge Fund Managers*, February 2000 ("Sound Practices"), at 3 (available on MFA's web site in the "Hedge Fund Materials" section at ***www.mfainfo.org***).

Although hedge funds, like mutual funds, are pooled investment vehicles managed by professional managers, hedge funds are distinguishable from mutual funds in many ways. For example, hedge funds and their managers tend to be small relative to mutual funds and their associated financial institutions. The President's Working Group observed that "most hedge funds are relatively small, with the vast majority controlling less than $100 million in invested capital."[4] In contrast, the largest mutual funds "have almost $100 billion in assets, and there are many [mutual] funds with assets over $10 billion."[5] In addition, as discussed further below, hedge funds restrict their shares to limited groups of sophisticated investors and, as a result, are not subject to the investment limitations of mutual funds. MFA believes these distinctions are important and should be preserved, for reasons discussed in greater detail below.

Hedge Funds Misunderstood. A number of commentators have observed that "little is understood about hedge funds and what they do."[6] MFA believes that many misconceptions about hedge funds and their activities may be attributed to the following:

- The absence of a legal or widely accepted definition of a hedge fund.
- The broad universe of investment strategies encompassed by the use of term "hedge fund".
- Legal restrictions on hedge funds' ability to engage in publicity or public solicitation. This prohibition on publicity may account for some of the "mystique" attributed to hedge funds and the limited public understanding of hedge fund investments.
- The focus of popular press coverage on rare instances of hedge fund failure or allegations of fraud by hedge fund managers rather than on the industry as a whole.

---

4 PWG Report at 2.

5 Robert A. Jaeger, *All About Hedge Funds*, at 57 (2003).

6 Stephen J. Brown & William N. Goetzmann, "Hedge Funds with Style", *The Journal of Portfolio Management*, Winter 2003, at 101-102.

- Restrictions on participation by the general investing public in hedge funds, which means that the public has limited exposure to or need to understand hedge funds.

MFA is hopeful that the Hearing together with the recent Senate hearing on hedge funds and undertakings by the SEC will contribute to a greater understanding of the hedge fund industry and serve to dispel misconceptions about hedge funds among regulators, legislators and the general public.

Regulatory Profile of Hedge Funds. Hedge funds restrict their shares to a limited group of qualified investors (as explained further under "Retailization of Hedge Funds") and do not engage in public offerings. By so doing, hedge funds are not required to register with the SEC and are therefore not subject to the investment and other limitations imposed upon registered investment companies. The fact that hedge funds are not registered does not mean, however, that that their activities are unregulated. Hedge funds and their managers are subject to a variety of regulations and are required to furnish significant information and reports to regulators in connection with their trading activities. See Annex B for a list of some of the reporting requirements and other regulations applicable to hedge funds and their activities in the United States.

A DIVERSITY OF STRATEGIES IN PURSUIT OF ABSOLUTE RETURNS

Broad Array of Investment Strategies. As noted above, the hedge fund industry represents a widely varied universe of investment styles and strategies.[7] The variety in investment approaches may be attributed to the fact that hedge funds are not subject to the types of legal investment restrictions placed on mutual funds (such as limitations on leverage and strategies such as short-selling) and are typically granted flexibility in their investment mandate by investors.

[7] A list of over 25 investment strategies and their definitions can be found at the web site for Hedge Fund Research, Inc. (*www.hedgefundresearch.com*).

Principal Strategies. The major hedge fund investment strategy classifications include the following:

- Long/short strategies for trading in equities.
- "Macro" or global directional investment strategies, which take positions in domestic and international currency, interest rate and equity markets based on global economic conditions and opportunities perceived to be presented by them.
- "Market-neutral", "relative value" or arbitrage strategies, which take offsetting long and short positions or otherwise hedged positions to reduce market risk and utilize leverage to achieve desired returns.
- Event-driven strategies, which seek to profit from anticipated events or special situations, such as mergers, restructurings, distressed securities.
- Regional strategies, which concentrate on a particular geographic region (such as emerging markets).
- Sector strategies, which focus on a particular industry.
- Long only, or "buy and hold", equity strategies, similar to traditional equity mutual fund strategies.
- Dedicated short sale equity strategies focusing on selling short securities that are deemed to be overvalued.
- Specific asset class strategies (such as currencies, commodities, interest rates).

These alternative investment strategies can present a more complex risk/reward ratio than those of traditional stock and bonds, which is one of the reasons why access to hedge fund investments is generally restricted to "accredited investors" or, in many cases, "qualified purchasers".[8]

Pursuit of "Absolute Returns". Many hedge fund managers engage in "absolute return" strategies, meaning that their returns do not depend on, nor are they benchmarked against,

[8] The qualifications for accredited investors and qualified purchasers are discussed further below in connection with the 3(c)(1) and 3(c)(7) exclusions from the Investment Company Act of 1940.

the long-term return of the markets or assets in which they invest. In other words, hedge funds seek to achieve positive returns based on the skill or strategy of the manager rather than meet or exceed the performance of the underlying market or asset class. This approach is distinguishable from that of most mutual funds, which typically seek to realize "relative" returns, or returns based upon the performance (whether it be positive or negative) of a certain market or relative to a market benchmark (like the S&P 500 stock index).[9] The fact that hedge fund strategies differ from those of mutual funds and other investment vehicles in this way allows hedge funds to provide investors with a valuable means of portfolio diversification, as discussed below.

BENEFITS OF HEDGE FUNDS

Public and private sector experts have recognized that hedge funds provide significant benefits to their investors as well as the financial markets more generally.

Benefits to Investors. Many hedge funds provide attractive mechanisms for portfolio diversification because their returns have little or no correlation to those of more traditional stock and bond investments. As a result, many hedge fund categories tend to outperform stock and bond investments when the latter perform poorly. Much of the growth in hedge funds since the 1980s can be attributed to the increasing recognition by institutional investors, confirmed by a growing body of academic research,[10] that hedge funds are an attractive alternative asset class that can help diversify returns and, in doing so, reduce the overall risk of an investment portfolio. As one academic paper summarized,

"hedge funds offer the opportunity to:

1) reduce portfolio volatility risk,

[9] For example, a mutual fund that seeks to track the S&P 500 would be considered successful if its annual performance were -15% in a year when the S&P 500 declined by 20%.

[10] See Annex A for a bibliography of academic and other research regarding the attributes and benefits of hedge fund investments cited herein.

2) enhance portfolio returns in economic environments in which traditional stock and bond investments offer limited opportunities, and

3) participate in a wide variety of new financial products and markets not available in traditional investor products."[11]

In addition, hedge fund managers typically have a substantial amount of their own capital invested in the funds they manage, and a significant portion of their compensation is based upon the absolute, or positive, performance they achieve for their investors. As New York Attorney General Eliot Spitzer observed recently, the interests of hedge fund managers and their investors tend to be "aligned"[12], largely due to this combination of the managers' commitment of capital to their funds and the performance-based compensation structure.

Benefits to the Global Financial Marketplace. Because many hedge funds are highly active participants in the markets they trade and can change their investment positions as circumstances warrant, they can move quickly and flexibly to respond to changes in market conditions. The active and informed participation of hedge funds in financial markets allows them to perform a number of important roles in the global financial market place, including the following:

- *Many hedge funds can act as "shock absorbers".* By standing ready to put capital at risk in volatile markets when other investors choose to remain on the sidelines, hedge funds employing investment strategies that rely on arbitrage, hedging or contrarian approaches help to absorb market shocks and act as a buffer for other market participants.[13] In doing so, hedge funds can inject needed liquidity into markets irrespective of market direction and "can be stabilizing influences"[14], reducing the severity of price fluctuations in severe market conditions.

[11] Thomas Schneeweis & Georgi Georgiev, *The Benefits of Hedge Funds*, Working Paper, Center for International Securities and Derivatives Markets, June 19, 2002. Dr. Schneeweis is a member of MFA's Board of Directors.

[12] Dina Temple-Raston, "Spitzer Offers Assurance to Hedge Fund Leaders", *New York Sun*, March 4, 2003.

[13] Sound Practices at 3.

[14] Statement of Treasury Deputy Assistant Secretary (Government Financial Policy) Lee Sachs Before the Subcommittee. on Capital Markets, Securities and Government-Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives (page 1) (1999).

- *Hedge funds enhance market liquidity and provide "depth".* As active trading participants in international capital markets, hedge funds provide systemic benefits by adding "depth and liquidity to financial markets".[15]

> *"...many of the things which [hedge funds] do ... tend to refine the pricing system in the United States and elsewhere, and it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient ... there is an economic value here which we should not merely dismiss...I do think it is important to remember that [hedge funds] – by what they do – they do make a contribution to this country." – Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, testifying before the Committee on Banking and Financial Services, U.S. House of Representatives regarding the collapse of Long Tem Capital Management. October 1, 1998.*

- *Hedge funds help to refine the pricing system, contributing to efficiencies in pricing and market stability.* By trading based on sophisticated and extensive market research, hedge funds provide markets with price information, which translates into pricing efficiencies. "Without Hedge Fund Managers' research and commitment of capital, the markets would have potentially wider price spreads, pricing inefficiencies and illiquidity."[16] In targeting temporary pricing inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations.

- *Many hedge funds act as a counterbalance to "herding".* Many hedge fund investment strategies can serve as a valuable counterbalance to "herd" buying behavior, where market participants take positions similar to those of other market participants without reasonable justification. "Herding behavior can create price 'bubbles', meaning that the price of a stock may at that time be more reflective of a temporary order imbalance or transitory excess demand for that stock, than a useful representation of demand based on the fundamentals of the underlying asset."[17] Many hedge fund managers that perceive this imbalance will assume market positions that tend to restore unnaturally inflated prices to their true level. This is particularly important given that many market participants, such as mutual funds, are long-biased, meaning they tend to hold long positions in the assets in which they invest. The speculative bubble of the late 1990s would have been even more significant without the willingness of market participants such as hedge funds to take a bearish position.

---

[15] Statement of John P. LaWare, Member, Board of Governors of the Federal Reserve System Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (1994).

[16] Sound Practices at 3.

[17] Judith Chase, "The State of Hedge Funds", *SIA Research Reports*, March 10, 2003 (Securities Industry Association).

"Our activities are trend bucking rather than trend following. We try to catch new trends early and in later stages we try to catch trend reversals. Therefore, we tend to stabilize rather than destabilize the market. We are not doing this as a public service. It is our style of making money." Statement of George Soros, Soros Fund Management, Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 13, 1994.

- *Hedge funds provide a critical source of liquidity to illiquid markets.* Unlike mutual funds, hedge funds often require investors to maintain their investments in a fund for a certain minimum "lock-up" period, which can extend for a year or more depending on the type of fund concerned. In addition hedge fund investors must typically provide advance notice of redemptions and may only redeem shares at certain specified times (month-end, quarterly). Given the longer redemption horizon and the more stable asset base, hedge funds have the ability to invest in relatively illiquid markets and structured investments, such as the mortgage derivatives, distressed securities and risk arbitrage markets, which depend upon access to stable pools of investment capital.

- *Many hedge funds are less likely to engage in "momentum trading".* "The predictability of purchases and redemptions by small retail investors in mutual funds depending on market conditions makes their managers particularly prone to "momentum trading", that is, buying into a rising market and selling into a falling market, increasing market volatility."[18] Because hedge funds impose longer redemption horizons on their investors, hedge funds have fewer incentives to engage in momentum trading.

- *Through short-selling, hedge funds indirectly act as "whistle blowers".* In certain recent cases hedge funds have been among the first market participants "to spot trouble" with certain issuers, and their trading activity effectively presaged the discovery of major issuer frauds.[19] For example, short interest in Enron ballooned from 13.8 million shares in mid-September 2001 to 31.1 million shares as of November 15, 2001, weeks before Enron filed for bankruptcy. As one research firm recommended,

[18] See *Hedge Funds and Financial Market Dynamics, Occasional Paper 166*, International Monetary Fund (May 1998) at 29; see also Brandon Becker and Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets* (February 2000) at 90-93, for a discussion of other reasons why hedge funds are viewed as being "a more stabilizing influence than other market participants."

[19] See Statement of James S. Chanos, Kynikos Associates, Ltd., Before the Committee on Energy and Commerce, Developments Relating to Enron Corp., U.S. House of Representatives, February 6, 2002; see also "Don't Shoot the Messenger - Why short-selling should be encouraged," *The Economist*, March 1, 2003.

"Investors should absolutely look at short interest because short sellers do better homework than buyers of stock."[20]

- *Certain hedge funds act as market and risk management innovators.* The employment of state-of-the-art trading and risk management techniques by certain leading hedge funds fosters financial innovation and risk sophistication among the market participants with which they deal.

"Hedge funds can and do provide positive benefits to financial markets. Their trading can increase market efficiency, in that positions taken to profit from temporary price discrepancies can reduce such gaps. Indeed, the risk-taking engaged in by hedge funds and major market participants can serve to correct incongruities in market valuations. I believe that attempts to eliminate or stifle this market activity will result in less efficiency and liquidity in the marketplace." Statement of CFTC Commissioner (now Chairman) James E. Newsome before the Committee on Agriculture, Nutrition and Forestry, United States Senate, December 16, 1998.

"RETAILIZATION" OF HEDGE FUNDS

As noted above, one of the reasons for growth in the hedge fund industry in recent years has been an increasing recognition by investors that hedge funds are an attractive alternative asset class that can diversify returns while reducing the overall risk of an investment portfolio. Other reasons that account for increased interest in hedge funds include recent declines in mutual fund returns and the movement of talented investment professionals to trading on behalf of hedge funds.

The growing investor interest in hedge funds has led to concerns regarding the "retailization" of hedge fund investments, that is, the potential for increased availability of hedge fund investments to less sophisticated investors.

Existing Investor Requirements for Hedge Funds. Hedge funds are required by law to limit their U.S. investors to those that satisfy special qualifications under the U.S. securities laws.

[20] Paul R. LaMonica, "Enron: Could your stock be next?", *CNNMoney*, November 30, 2001.

[21] Judith Burns, "SEC Finds No Evidence of 'Retailization' in Hedge Funds", Dow Jones News Service, May 16, 2003, quoting SEC Commissioner Cynthia Glassman.

The specific investor qualifications with which a hedge fund must comply depend upon the exclusion from the Investment Company Act of 1940 (the "1940 Act") that is applicable to the hedge fund. The principal exclusions and their associated investor qualifications are summarized below.

- *Section 3(c)(1).* This exclusion provides that an investment fund will not be required to register as an investment company under the 1940 Act if: (a) it has no more than 100 investors and (b) it does not offer its shares publicly. In order to comply with the latter requirement, a fund sponsor will effectively limit the offering of fund shares to "accredited investors", as defined in Regulation D of the U.S. Securities Act of 1933. In addition to banks and other institutional investors, accredited investors include natural persons with individual or joint net worth of $1 million or individual income in each of the last two years in excess of $200,000, or joint income for the same period in excess of $300,000.[22]

- *Section 3(c)(7).* This exclusion provides that an investment pool will not be required to register under the 1940 Act if each investor in the pool is a "qualified purchaser" and the pool does not undertake a public offering. The term qualified purchaser includes: natural persons who have at least $5 million in investments; persons who, acting for themselves or the accounts of other qualified purchasers, in the aggregate own and invest on a discretionary basis not less than $25 million in investments; certain qualifying trusts; and institutional investors.

MFA believes that the existing regulatory structure as applied to hedge funds – which bars retail investors from directly investing in hedge funds and prohibits hedge funds from advertising or engaging in general solicitation of the public – has worked well and continues to be sound. This structure appropriately seeks to achieve investor protection by limiting hedge funds to investors who have been deemed sufficiently sophisticated and capable of determining for themselves whether the risk-reward profile presented by hedge fund investments is appropriate to their investment needs. To the extent that Congress or the SEC believes it appropriate to revisit existing investor qualifications as they apply to hedge funds, MFA would be pleased to participate in any such undertaking and to explore ways in

[22] For a detailed discussion of the requirements applicable to 3(c)(1) funds as well as Regulation D, see Barry P. Barbash & Emanuel D. Strauss, *Navigating Among Icebergs: The U.S. Regulatory Scheme Involved in Organizing and Operating Private Investment Funds*, presented as part of the International Conference on Private Investment Funds, February 24-26, 2002.

which these qualifications may be modified in order to achieve legitimate investor protection goals.

Funds of Hedge Funds. In response to growing investor demand for hedge fund investments, certain regulated entities have begun offering their clients shares in registered investment companies that invest in hedge funds, or "funds of hedge funds" that are registered with the SEC. As Chairman Donaldson stated in his recent testimony before the Senate Banking committee, the first of these products was registered with the SEC less than a year ago; since that time, an additional 17 have been approved for public offering. Because these funds were registered under the U.S. Securities Act of 1933 and the Investment Company Act of 1940, their shares could be offered publicly to investors that meet lower financial net worth and sophistication standards than those required of direct hedge fund investors. As confirmed at the SEC's recent Roundtable, despite the potential ability to offer shares more broadly, the sponsors of these funds to date have not offered these products to retail investors; rather, they have voluntarily restricted them to accredited investors or investors that are "qualified clients"[23] and generally imposed minimum investment requirements of between $25,000 and $100,000 (and in some cases $1 million). However, there is no legal requirement to impose investor eligibility standards or investment minimums, and "it is possible that funds might seek to lower this requirement making these types of funds available to a greater number of investors with even less capital."[24]

MFA recognizes that the offering of these new registered fund products more widely raises legitimate federal interests. Although a broader class of investors may have legitimate interests in diversifying their investment portfolios to include hedge fund strategies and returns, it is important that these investors be capable of assessing and understanding the risks associated with such investments. Consequently, MFA believes it is appropriate for the

[23] As defined in 205-3 of the Investment Company Act of 1940, which generally requires that the net worth of an investor (together with spouse) exceed $1.5 million or that the investor be a "qualified purchaser," owning at least $5 million in investments.

[24] Statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission Before the Committee on Banking, Housing and Urban Affairs, United States Senate, "Investor Protection Implications of Hedge Funds," (April 10, 2003) ("Donaldson Statement"), at 17.

SEC to consider the types of investments being made by registered investment companies and to monitor the offer and sale of these new products to ensure that they are suitable for their investors. In particular, MFA supports the undertakings of the SEC and the National Association of Securities Dealers to ensure that regulated broker-dealers are complying with applicable securities laws and regulations in offering these investments to their clients.[25] MFA is confident that, through the fund registration process as well as the regulation of entities offering these registered fund products, the SEC has adequate authority to supervise and regulate the development and offering of these products.

REGISTRATION

As noted above, hedge funds are not required to register with the SEC (and are therefore not subject to the investment and other limitations imposed upon registered investment companies) because they elect to comply with certain exclusions under the Investment Company Act of 1940 which require them to offer their shares privately to a restricted group of qualified investors. Similarly, many hedge fund managers are not required to register with the SEC because they elect to comply with registration exemptions available under the Investment Advisers Act. Registration is a choice that is made by a hedge fund manager based on its particular business model.

The current regulatory framework reflects a long-established principle that scarce federal resources should be dedicated to protecting the retail investor public rather than institutional and sophisticated high net worth investors who are able to fend for themselves. MFA believes that this framework as applied to investment advisers works well and reflects carefully constructed exemptions based on thoughtful public policy-driven choices. It has not yet been demonstrated that mandating SEC-registration and regulation of all hedge fund managers is the most effective or efficient way to address concerns that have been raised

[25] The NASD recently published a "Notice to Members" in February 2003 reminding its members of their suitability and other obligations when selling funds of hedge funds to their customers.

regarding hedge funds. Any additional or new regulation has costs and consequences and must carefully be weighed against the benefits of such regulation. As the PWG said in its Report following LTCM, "[a]ny resort to government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes."[26] MFA would be pleased to work with the Subcommittee and other public policy makers in any undertaking to re-examine the current regulatory framework as it applies to hedge fund managers.

CONFLICTS

Certain mutual fund managers have begun managing hedge funds in addition to the mutual funds they have traditionally managed. Some observers have questioned whether managing a hedge fund alongside a mutual fund creates potential conflicts of interests for the mutual fund manager. For example, if the hedge fund's compensation structure pays the manager a share of trading profits as a performance fee, the investment adviser may be "tempted to favor its hedge fund clients over its registered investment company clients in allocating lucrative trades".[27]

MFA supports the efforts of the SEC to ensure that mutual fund managers treat their investors fairly and equitably. MFA is confident that the SEC has the authority to supervise and regulate mutual fund managers and to address the potential conflicts of interest presented by offering mutual funds and hedge funds side by side.

VALUATION

While mutual funds are subject to regulations governing the valuation of the assets they hold, hedge funds are required to perform valuations consistent with their agreements with investors. For example, most hedge funds commit to perform valuations and maintain their accounts in accordance with U.S. generally accepted accounting principles, or GAAP, and to have their accounts audited annually by an internationally recognized audit firm. In addition,

[26] PWG Report at 35.

[27] Donaldson Statement at 13.

hedge fund valuation determinations, like those of mutual funds and other investment vehicles, are subject to the antifraud provisions of the federal securities laws.

As with mutual funds, sound valuation practices are critically important to hedge funds because these practices determine the price at which investors subscribe and redeem shares of the fund. A group of hedge fund managers stressed the importance of proper valuation procedures in *Sound Practices for Hedge Fund Managers*,[28] stating that "Senior Management should determine policies for the manner and frequency of computing [Net Asset Value] based upon applicable GAAP and disclose such policies to investors. Such policies should establish valuation methods that are consistent and fair to both buyers and sellers." The *Sound Practices* report also recommended that valuations "be periodically validated by independent internal or external review, preferably on a monthly basis, but no less frequently than annually. The accuracy of [Net Asset Value] calculations should be verified by external auditors at least annually to assure compliance with GAAP." The portions of *Sound Practices for Hedge Fund Managers* that address valuation are attached as Annex C.

MFA strongly endorses the principles detailed in *Sound Practices for Hedge Fund Managers* with respect to valuation procedures. MFA believes that hedge fund investors are capable of demanding the disclosures they require to determine whether a hedge fund's valuation and accounting policies and audit program are appropriate and adequate. The hedge fund manager's response to those demands is subject to the anti-fraud provisions of the federal securities laws as well as their contractual obligations to investors. Consequently, MFA does not believe that new regulation is required to address valuation methods employed by hedge funds.

FRAUD

As the hedge fund industry has grown into an estimated $600 billion industry with over 6,000 firms, the number of investigations undertaken by the SEC into allegations of fraud by

[28] Sound Practices at 10-12 and Appendix I, I-5 to I-8..

hedge funds has also grown.[29] While the number of these investigations may have increased, MFA believes that there are relatively few instances of fraud relating to hedge funds in comparison to the size of the industry. SEC Chairman Donaldson recently acknowledged that he has "no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else."[30]

Certain recent cases involving hedge funds have involved fraudulent valuations by the hedge fund, or fraud by the hedge fund as issuer. As noted above under "Valuation", a hedge fund's obligations with respect to valuations are governed by their agreement with investors as well as by the anti-fraud provisions of the U.S. securities laws. To the extent a hedge fund engages in accounting fraud or fraud with respect to the valuation of its shares, the hedge fund, similar to any other issuer that engages in such forms of fraud, may be liable for violations of federal securities laws, as well as violations of its contractual obligations to investors.

With respect to fraud on the market more generally, it is important to recognize that, like other market participants, all hedge funds and their managers and advisors are subject to the broad anti-fraud and anti-manipulation provisions of the U.S. Securities Act of 1933, the U.S. Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 which prohibit fraud in connection with the offer, sale and purchase of securities and in connection with the advisory relationship.[31] Hedge fund managers are also subject to the U.S. securities laws' prohibitions on insider trading. Hedge funds that engage in futures trading are also subject to the anti-fraud and anti-manipulation provisions of the U.S. commodities laws. In addition U.S. hedge funds (and hedge funds with a U.S. nexus) are expected to be required to comply with certain key anti-money laundering provisions of the *USA PATRIOT Act* once final rules are promulgated with respect to hedge funds.

---

[29] A list of recent Commission enforcement actions involving hedge funds may be found at ***http://www.sec.gov/divisions/enforce/enforceactions.shtml***

[30] Donaldson Statement at 19.

[31] See Annex B for a detailed list of the anti-fraud and anti-manipulation provisions to which hedge funds are subject.

MFA believes that there exists no basis for treating hedge funds differently from other issuers or market participants with respect to instances of fraud and that the regulatory framework currently in place is adequate to enable the Enforcement Division at the SEC to prosecute allegations of fraud under the federal securities laws.

> *"[T]he Commission has a solid record of uncovering hedge fund fraud and recovering a portion of the victims' assets." Stephen M. Cutler, Director of Commission Division of Enforcement, Sept. 2001.*

SYSTEMIC RISK

The Lessons of Long-Term Capital Management. Although many public and private sector commentators have acknowledged that Long-Term Capital Management ("LTCM") was unique in terms of both its size and the levels of leverage it employed, the market turbulence that followed the near-collapse of LTCM in 1998 led both the public and private sectors to focus renewed attention on ways to reduce systemic risk.[32]

One notable public sector response was the report published by the President's Working Group on Financial Markets (consisting of the Secretary of the Treasury and the Chairpersons of the SEC, the Federal Reserve and the Commodity Futures Trading Commission) entitled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (the "PWG Report"). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excessive leverage, recognizing that "[a]ny resort to government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes."[33] Rather than propose any direct regulation of hedge funds, the PWG Report's recommendations called for "indirect regulation" of unregulated market participants. One of the products of this

[32] Charles Adams, Donald J. Mathieson, and Gary Schinasi, *World Economic and Financial Surveys: International Capital Markets – Developments, Prospects, and Key Policy Issues* (September 1999) at 152; see generally Brandon Becker and Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets* (February 2000).

[33] PWG Report at 35.

recommendation was the publication of *Sound Practices for Hedge Fund Managers* by the hedge fund industry in response to the PWG Report.

The response advocated by the private sector was comparable to that of the PWG Report. For example, the Counterparty Risk Management Policy Group ("CRMPG"), a group of twelve major international investment and commercial banks, proposed a voluntary framework for enhanced counterparty credit risk management rather than endorse regulation of hedge fund counterparties.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the CRMPG framework and *Sound Practices for Hedge Fund Managers*, have successfully reduced the exposure of global financial markets to systemic risk. Consequently, MFA does not believe that new regulation to address this risk is necessary.

> *"Although I believe the LTCM debacle exposes serious and systemic problems in creditor monitoring of large institutional borrowers, I do not believe that it supplies any persuasive justification for direct regulation of hedge funds ... [T]he problem with direct regulation of hedge funds is two fold: (1) Investor protection – the traditional primary goal of SEC regulation – does not supply a coherent justification for regulation of hedge funds; and (2) Regulation is likely to drive hedge funds off shore." John C. Coffee, Professor, Columbia University School of Law, testifying before the Banking Committee, U.S. House of Representatives, May 6, 1999.*

SHORT-SELLING

In periods of bear markets, as in the present time, the topic of short selling becomes controversial, particularly among those who have an interest in seeing market prices rise. Critics of short selling practices often claim that short-sellers unfairly collude to drive down stock prices; however, academic research has been unable to link the most recent market declines to any single trading strategy.[34]

> *"I am not saying anything critical of short selling. It has nearly always been an aspect of our marketplace that has been useful and beneficial. The people who first highlighted the problems at Enron were short sellers." Eliot Spitzer, New York Attorney General, March 3, 2003.*

MFA believes that there is no demonstrated need to further restrict short-selling or to tilt the playing field further toward the long side by implementing additional restrictions on short-sellers akin to the "uptick rule." To the extent that the Subcommittee believes that the impact of short-selling or other trading strategies on the market or certain issuers merit consideration, MFA believes that the Subcommittee would have to evaluate many factors and the potential impact on many market participants in evaluating the regulatory framework applicable to short selling before any meaningful conclusions could be drawn. Although many hedge funds may engage in investment strategies that involve short-selling, many other market participants do as well. Consequently, if a re-examination of short-selling is to be undertaken, MFA believes that it should be done in concert with the Division of Market Regulation of the SEC, the Federal Reserve, the Commodity Futures Trading Commission and the Treasury, as well as representatives of the industries that would be impacted by increased regulation.

MFA believes that short selling is not only a legitimate investment activity, but one that plays an important role in improving market efficiency and price discovery. By allowing

[34] See, e.g., Thomas Schneeweis and Richard Spurgin, "Market Crashes, Speculation and Hedge Funds", *AIMA Newsletter* (Sept. 2002) at 1.

market participants to place short positions on particular securities that they believe to be over-valued, the existing regulatory scheme allows investors not only to protect their own investment portfolios, but also to reduce market volatility and help bring asset valuations back into line. As noted above, short-selling serves as an important counter balance to "bubble" markets and the long biases of other market participants. In several recent cases, hedge funds have acted indirectly as "whistle-blowers" by engaging in short-selling, the validity of which was later borne out by discoveries of fraud or other misconduct by the issuers concerned.[35] SEC Chairman Donaldson acknowledged in his recent statement before the Senate Banking committee that "[t]here is nothing inherently nefarious about hedge fund trading strategies, including short selling."[36]

> *"The evidence on subsequent stock returns suggests that in public battles between short sellers and firms, short sellers usually are vindicated by subsequent events. The evidence suggests that short sellers play an important role in detecting not just overpricing, but also fraud. Policy makers might want to consider making the institutional and legal environment less hostile to short sellers." Owen A. Lamont, Associate Professor of Finance at the Graduate School of Business, University of Chicago commenting on the data in his study of battles between short sellers and firms entitled, "Go down fighting: Short sellers vs. firms"*.[37]

The prospect of additional regulation of short selling raises fundamental market issues that go far beyond those related to the trading activities of hedge funds. It potentially affects the efficiency and volatility of U.S. equity markets and the position of U.S. market participants in the world financial system. The adoption of additional short selling rules could constitute a rash and harmful overreaction to isolated incidents of alleged impropriety that would be better addressed under the existing anti-fraud provisions of the U.S. securities laws.

[35] Owen A. Lamont, *Go down fighting: Short sellers vs. firms*, Working Paper, Graduate School of Business, University of Chicago and National Bureau of Economic Research (January 9, 2003) ("University of Chicago Study").

[36] Donaldson Statement at 21.

[37] University of Chicago Study at 30-31.

CONCLUSION

MFA is pleased to offer this written statement in connection with the Hearing and hopes that they serve to properly frame the issues that participants may wish to address. MFA looks forward to working with the SEC on any efforts that it determines to undertake in the future that may be of relevance to the hedge fund industry.

Annex A

BIBLIOGRAPHY

A. Materials Cited Herein

<u>Government Materials:</u>

Reports:

President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long Term Capital Management*, April 1999.

Hedge Funds and Financial Market Dynamics, Occasional Paper 166, International Monetary Fund (May 1998).

Testimony:

Statement of James S. Chanos, Kynikos Associates, Ltd., Before the House Committee on Energy and Commerce, Developments Relating to Enron Corp., February 6, 2002.

Statement of John C. Coffee, Professor, Columbia University School of Law, Before the House Banking Committee, May 6, 1999.

Statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission Before the Committee on Banking, Housing and Urban Affairs, United States Senate, "Investor Protection Implications of Hedge Funds," April 10, 2003.

Statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, Before the Committee on Banking and Financial Services, U.S. House of Representatives, October 1, 1998.

Statement of John P. LaWare, Member, Board of Governors of the Federal Reserve System Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (1994).

Statement of CFTC Commissioner (now Chairman) James E. Newsome before the Committee on Agriculture, Nutrition and Forestry, United States Senate, December 16, 1998.

Statement of Treasury Deputy Assistant Secretary (Government Financial Policy) Lee Sachs Before the Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives (1999).

Statement of George Soros, Soros Fund Management, Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 13, 1994.

Notices

Notice to Members, National Association of Securities Dealers (NASD), February 2003 ("NASD Reminds Members of Obligations When Selling Hedge Funds").

Industry Materials:

Sound Practices for Hedge Fund Managers, prepared by members of hedge fund industry (February 2000).

Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs, Managed Funds Association (March 2002).

Barry P. Barbash & Emanuel D. Strauss, "Navigating Among Icebergs: The U.S. Regulatory Scheme Involved in Organizing and Operating Private Investment Funds," presented as part of the International Conference on Private Investment Funds, February 24-26, 2002.

Judith Chase, "The State of Hedge Funds," *SIA Research Reports,* March 10, 2003 (Securities Industry Association).

Academic Materials:

Charles Adams, Donald J. Mathieson, and Gary Schinasi, *World Economic and Financial Surveys: International Capital Markets – Developments, Prospects, and Key Policy Issues* (September 1999).

Brandon Becker and Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets* (February 2000).

Stephen J. Brown & William N. Goetzmann, "Hedge Funds with Style," *The Journal of Portfolio Management,* Winter 2003.

Robert A. Jaeger, *All About Hedge Funds* (2003).

Owen Lamont, *Go down fighting: Short sellers vs. firms,* Working Paper, Graduate School of Business, University of Chicago and National Bureau of Economic Research, January 9, 2003.

Thomas Schneeweis & Georgi Georgiev, *The Benefits of Hedge Funds,* Working Paper, Center for International Securities and Derivatives Markets, June 19, 2002.

Thomas Schneeweis and Richard Spurgin, Market Crashes, "Speculation and Hedge Funds," *AIMA Newsletter* (Sept. 2002).

News Media:

Paul R. LaMonica, "Enron: Could your stock be next?", *CNNMoney,* November 30, 2001.

Dina Temple-Raston, "Spitzer Offers Assurance to Hedge Fund Leaders", *New York Sun,* March 4, 2003.

"Don't Shoot the Messenger - Why short-selling should be encouraged," *The Economist,* March 1, 2003.

Web sites:

Securities and Exchange Commission (www.sec.gov)

Hedge Fund Research, Inc. (www.hedgefundresearch.com/pdf/HFR_Strategy_Definitions.pdf)

Managed Funds Association (www.mfainfo.org)

B. Additional Academic Source Materials on the Benefits of Hedge Funds

Ackermann, C., R. McEnally, and D. Ravenscraft, 1999, "The Performance of Hedge Funds: Risk, Return and Incentives", *Journal of Finance*, 54(3), 833-874.

Agarwal, Vikas and Narayan Y, Naik, 2000a, "On Taking the Alternative Route: Risks, Rewards, and Performance Persistence of Hedge Funds," *Journal of Alternative Investments*, Volume 2, Number 4, 6-23.

Agarwal, Vikas and Narayan Y, Naik, 2000b, "Performance Evaluation of Hedge Funds with Option-based and Buy and Hold Strategies," Working Paper, London Business School.
Amin, G. and H. Kat, 2001, "Hedge Fund Performance 1990-2000," Working Paper, ISMA Centre.

Asness, Clifford, R. Krail, J. Liew, 2001, "Do Hedge Funds Hedge?" *Journal of Portfolio Management*, forthcoming.

Bodie, Z., M. Kane, and A. Marcus. 2000. *Investments.*

Brealey, R.A and E. Kaplanis, 2000, "Changes in Factor Exposures of Hedge Funds", Working paper, Bank of England and Institute of Finance and Accounting, London Business School.

Brown, Stephen, William Goetzmann and Roger G. Ibbotson, 1999, "Offshore Hedge Funds: Survival and Performance 1989-95," *Journal of Business*, 72, 91-117.

Brown, Stephen, William Goetzmann and J. Park, 1997, "Conditions for Survival: Changing Risk and The Performance of Hedge Fund Managers and CTAs," *Review of Financial Studies*, 5, 553-580.

Crossborder Capital, 2001, "Fund Age and Performance," *Journal of Alternative Investments*, forthcoming.

Deutsche Bank, (Research Reports, 2000).

Fama, Eugene F. and Kenneth French, 1996, "Multifactor Explanations of Asset Pricing Anomalies," *Journal of Finance*, 51, 55-84.

Fama, Eugene and Kenneth French, 1993, "Common Risk Factors in the Returns on Stock and Bonds," *Journal of Financial Economics*, 33, 3-56.

Fung, W. and D. A. Hsieh, 1997a, "Empirical Characteristics of Dynamic Trading Strategies: The Case of Hedge Funds," *Review of Financial Studies*, 10, 275-302.

Fung, W. and D.A. Hsieh, 1997b, "Survivorship Bias and Investment Style in the Returns of CTAs," *Journal of Portfolio Management*, 24(1), 30-41.

Fung, W. and D.A.Hsieh, 1999a, "A Primer on Hedge Funds", *Journal of Empirical Finance*, 6, 309-331.

Fung, W., D.A.Hsieh and K Tsatsaronic, 1999b, "Do Hedge Funds Disrupt Emerging Markets?" forthcoming in Brookings –Wharton Papers on Financial Services.

Fung, W. and D.A.Hsieh, 2000a, "The Risk in Hedge Fund Strategies: Theory and Evidence from Trend Followers," forthcoming in *Review of Financial Studies.*

Fung, W. and D.A.Hsieh, 2000b, "Performance Characteristics of Hedge Funds and CTA Funds: Natural Versus Spurious Biases," forthcoming in *Journal of Financial and Quantitative Analysis.*

Fung, W. and D.A.Hsieh, 2000c, "Measuring the Market Impact of Hedge Funds", *Journal of Empirical Finance*, 7 (1), 1-36.

Fung, W. and D.A. Hsieh, 2000d, "Benchmarks of Hedge fund Performance: Information Content and Measurement Biases," *Financial Analysts Journal*, forthcoming.

Henriksson, R, D, and R.C. Merton, 1981, "On Market Timing and Investment Performance II: Statistical Procedures for Evaluating Forecasting Skills," Journal of Business, 54 (4), 513-533.

Jagannathan, Ravi and Robert Korajczyk, 1986, "Assessing the market timing performance of managed portfolios," *Journal of Business*, 59, 217-235.

Kazemi, Hossein and Thomas Schneeweis, 2001, "Traditional Asset and Alternative Asset Allocation," CISDM/SOM Working Paper, University of Massachusetts.

Koski, Jennifer Lynch and Jeffrey Pontiff, 1999, " How Are Derivatives Used? Evidence from the Mutual Fund Industry," *Journal of Finance*, 54 (2), 91-816.

Lehmann, B.N. and D.M Modest, 1987, "Mutual Fund Performance Evaluation: A Comparison of Benchmarks and Benchmark Comparisons," *Journal of Finance*, 42, 233-265.

Liang, Bing, 1999, "On the Performance of Hedge Funds," *Financial Analysts Journal*, July/August, 72-85.

Liang, Bing, 2000, "Hedge Funds: The Living and The Dead", forthcoming in *Journal of Financial and Quantitative Analysis.*

Liang, Bing, 2001, "Hedge Fund Performance: 1990-1999," *Financial Analysts Journal*, January/February, 11-18.

Martin, G., 2001, "Making Sense of Hedge Fund Returns: A New Approach," in *Added Value in Financial Institutions: Risk or Return*, E. Acar (ed.), London: FT Publishing.

Martin, G., McCarthy, D., and T. Schneeweis. 1997 "Return Interval Selection and CTA Performance Analysis," *Derivatives Quarterly*, Summer, 73-82.

Martin, George and Richard Spurgin, 1998, "Skewness in Asset Returns: Does It Matter," *The Journal of Alternative Investments*, Fall, 66-75.

McCarthy, D. and Richard. Spurgin, 1998. "A Review of Hedge Fund Performance Benchmarks" *Journal of Alternative Investments*, Summer . 18-28.

Merton, R.C., 1981, "On Market Timing and Investment Performance I: An Equilibrium Theory of Value for Market Forecasts," *Journal of Business*, 54(3), 363-406.

Mitchell, M. and T. Pulvino, 2000, "Characteristics of Risk in Risk Arbitrage", Working Paper, Harvard Business School and Kellogg Graduate School of Management.

Richards, A., 1999, "Idiosyncratic Risks: An Empirical Analysis, with Implications for the Risk of Relative-Value Trading Strategies", Working Paper, International Monetary Fund.

Schneeweis Partners, 2001. *A Review of Alternative Hedge Fund Indices.*

Schneeweis, Thomas, 1998, "Evidence of Superior Performance Persistence in Hedge Funds: An Empirical Comment," *The Journal of Alternative Investments*. Fall. 76-80.

Schneeweis, Thomas, and Hossein Kazemi. 2001, "Alternative Means of Replication Hedge Fund Manager Performance," CISDM/SOM, University of Massachusetts.

Schneeweis, Thomas and Richard Spurgin, 1998, "Multifactor Analysis of Hedge Fund, Managed Futures and Mutual Fund Return and Risk Characteristics," *Journal of Alternative Investments*, 1, 1-24.

Schneeweis, Thomas and R. Spurgin, 1999, "Quantitative Analysis of Hedge Fund and Managed Futures Return and Risk Characteristics," in P. Lake ed. *Evaluating and Implementing Hedge Fund Strategies* (2nd ed.).

Schneeweis, Thomas and Joseph Pescatore eds. 1999. *The Handbook of Alternative Investment Strategies: An Investor's Guide.* Institutional Investor.

Schneeweis, Thomas and Richard Spurgin, 1998 "Sources of Return to Systematic CTA Traders," Working Paper, CISDM/SOM, University of Massachusetts.

Schneeweis, Thomas and H. Kazemi, 2001 "The Creation of Alternative Tracking Portfolios for Hedge Fund Strategies," Working Paper, CISDM/SOM, University of Massachusetts.

Schneeweis, Thomas and R. Spurgin, 2001, "Trading Factors and Location Factors in Hedge Fund Return Estimation," CISDM/SOM, University of Massachusetts.

Schneeweis, Thomas, R. Spurgin, and M. Potter, "Managed Futures and Hedge Fund Investment for Downside Equity Risk Management," *Derivatives Quarterly*, (Fall 1996), pp. 62-72.

Schneeweis, Thomas, Richard Spurgin and David McCarthy, 1996, "Survivor Bias In Commodity Trading Advisor Performance," *Journal of Alternative Investments*, 1, 1-24.

Schneeweis, Thomas, H. Kazemi, and R. Spurgin, 2001, "Volatility Factors and Hedge fund Return," CISDM/SOM, University of Massachusetts.

Sharpe, W., 1992, "Asset Allocation: Management Style and Performance Measurement," *Journal of Portfolio Management*, Vol. 18, 7-19.

Zurich Hedge Fund Indices. 2001. Zurich Capital Markets, NYC.

* * *

Managed Funds Association maintains a library of hedge fund industry materials, many of which are accessible on its web site at **www.mfainfo.org**. These materials include government reports on hedge funds, Congressional testimony and regulator speeches regarding hedge funds, legislation and rules relevant to hedge funds, as well as academic industry papers and reports on hedge funds.

Annex B

SOUND PRACTICES FOR HEDGE FUND MANAGERS

U.S. REGULATORY FILINGS BY HEDGE FUND MANAGERS[38]

Listed below are regulatory filings (excluding tax-related and state "blue sky" filings) that Hedge Fund Managers may be required to make in the United States depending on either their trading activity or their status as a regulated entity. The filings made to regulators by individual Hedge Fund Managers will vary depending on the type and volume of trading in which they engage, their business model and the jurisdictions in which they operate. For example, like other market participants and institutional investors, Hedge Fund Managers are required to make certain filings in the United States if the size of the positions they hold in certain markets reaches "reportable" levels. In addition, some Hedge Fund Managers are regulated entities in the United States or are otherwise subject to a regulatory regime, and, like other similarly situated entities, are required to make certain filings in that capacity. This appendix lists filings required in the United States where the above circumstances apply to a Hedge Fund Manager. Hedge Fund Managers may also be subject to regulatory reporting and filing requirements in the foreign jurisdictions in which they conduct their business.

Federal Reserve

Treasury Securities Position and Foreign Exchange Transaction Reporting

1. *Large Position Reporting*	Report of positions in specific Treasury security issues that exceed the large position threshold specified by the U.S. Treasury Department (minimum $2 billion). Reports are filed in response to notices issued by the U.S. Department of the Treasury if such threshold is met. Reports are filed with the Federal Reserve Bank of New York and are not public.
2. *Form FC-1*	Report of weekly, consolidated data on the foreign exchange contracts and positions of major market participants. Reports to be filed throughout the calendar year by each foreign exchange market participant which had more than $50 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year.

[38] The content of this Annex B reproduces Appendix II of *Sound Practices for Hedge Fund Managers* (February 2000). Capitalized terms have the meanings given to them in that document.

The report is filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of the Treasury and is confidential.

3. *Form FC-2*

Report of monthly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants.

Reports to be filed throughout the calendar year by each foreign exchange market participant which had more than $50 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year.

The report is filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of the Treasury and is confidential.

4. *Form FC-3*

Report of quarterly, consolidated data on the foreign exchange contracts and foreign currency denominated assets and liabilities of major market participants.

Reports to be filed throughout the calendar year by each foreign exchange market participant which had more than $5 billion equivalent in foreign exchange contracts on the last business day of any calendar quarter during the previous year and which does not file Form FC-2.

The report is filed with the appropriate Federal Reserve Bank acting as agent for the U.S. Department of the Treasury and is confidential.

Treasury Auction Filings

5. *Treasury Auction*

Treasury security reports filed as necessary. Confirmations must be filed by any customer who is awarded more than $500 million of U.S. government securities in a Treasury auction. The confirmation must include its reportable net long position, if any.

The confirmation is filed with the Federal Reserve Bank to which the bid was submitted and is not public.

Treasury International Capital Forms

6. *Forms CM, CQ-1* and *CQ-2*

Forms filed by U.S. persons who have claims on, or financial liabilities to unaffiliated foreigners, have balances on deposit with foreign banks (in the U.S. or abroad) or otherwise engage in transactions in securities or other financial assets with foreigners. Forms CQ-1 ("Financial Liabilities to, and Claims on, Unaffiliated Foreigners") and CQ-2 ("Commercial Liabilities to, and Claims on,

Unaffiliated Foreigners") are quarterly reports, which collect data on financial and commercial liabilities to, and claims on, unaffiliated foreigners held by non-banking enterprises in the United States, which must be filed when the consolidated total of such liabilities are $10 million or more during that period. Form CM ("Dollar Deposit and Certificate of Deposit Claims on Banks Abroad") is a monthly report whereby non-banking enterprises in the U.S. report their total dollar deposit and certificate of deposit claims on foreign banks, which must be filed when the consolidated total of such claims are $10 million or more during that period.

The forms are filed with the Federal Reserve Bank of New York are non-public except for aggregate information.

7. *Form S* — Form filed by any U.S. person who purchases or sells $2 million or more of long-term marketable domestic and foreign securities in a month in direct transactions with foreign persons.

The form is filed with the Federal Reserve Bank of New York and is non-public except as to aggregate information.

Securities and Exchange Commission ("SEC")

Sale of Securities by an Issuer Exempt from Registration under Reg. D or 4(6)

8. *Form D* — Notice of sale filed after securities, such as interests in a private hedge fund, are sold in reliance on a Regulation D private placement exemption or a Section 4(6) exemption from the registration provisions of the 1933 Act. The form is filed with the SEC and relevant states and is publicly available.

Secondary Sale of Restricted and Control Securities Under Rule 144

9. *Form 144* — Form filed as notice of the proposed sale of restricted securities or securities held by an affiliate of the issuer in reliance on Rule 144 when the amount to be sold during any three month period exceeds 500 shares or units or has an aggregate sales price in excess of $10,000. The form is filed with the SEC and the principal national securities exchange, if any, on which such security is traded and is publicly available.

Ownership of Equity Securities Publicly Traded in the United States

10. *Schedule 13D* — Disclosure report for any investor, including a hedge fund and its fund manager, who is considered beneficially to own more than 5% of a class of equity securities publicly traded in the U.S. The report identifies the source and amount of the funds used for the acquisition and the purpose of the acquisition.

This reporting requirement is triggered by direct or indirect acquisition of more than 5% of beneficial ownership of a class of equity securities publicly traded in the U.S. Amendments must be filed promptly for material ownership changes. Some investors may instead report on short-form Schedule 13G if they are eligible. See "11. Schedule 13G"

The report is filed with the SEC and is publicly available.

11. *Schedule 13G*

Short form disclosure report for any passive investor, including a hedge fund and its fund manager, who would otherwise have to file a Schedule 13D but who owns less than 20% of the subject securities (or is in certain U.S. regulated investment businesses) and has not been purchased for the purpose of influencing control.

This reporting requirement is triggered by direct or indirect acquisition of beneficial ownership of more than 5% of a class of equity securities publicly traded in the U.S. Amendments must be filed annually if there are any changes, and either monthly (for U.S. regulated investment businesses) or promptly (for other passive investors) if ownership changes by more than 5% of the class

The report is filed with the SEC and is publicly available.

12. *Forms 3, 4 and 5*

Every director, officer or owner of more than 10% of a class of equity securities of a domestic public company must file a statement of ownership. The initial filing is on Form 3 and changes are reported on Form 4. The Annual Statement of beneficial ownership of securities is on Form 5. The statements contain information on the reporting person's relationship to the company and on purchases and sales of the equity securities.

Form 3 reporting is triggered by acquisition of more than 10% of the equity securities of a domestic public company, the reporting person becoming a director or officer, or the equity securities becoming publicly traded, as the case may be. Form 4 reporting is triggered by any open market purchase, sale, or an exercise of options of those reporting under Form 3. Form 5 reporting is required annually for those insiders who have had exempt transactions and have not reported them previously on a Form 4.

The statements are filed with the SEC and are publicly available.

Registered and Unregistered Institutional Investment Managers

13. *Form 13F*

Quarterly position report for registered and unregistered institutional investment managers (*i.e.*, any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person) with investment

discretion over $100 million or more in equity securities publicly traded in the U.S. Reports contain position information about the equity securities under the discretion of the fund manager, and the type of voting authority exercised by the fund manager.

The reporting requirement is triggered by an institutional investment manager holding equity securities having an aggregate fair market value of at least $100 million on the last trading day of a calendar year and require a report as of the end of that year and each of the next three quarters.

The reports are filed with the SEC and are publicly available.

Material Associated Persons of Registered Broker-Dealers

14. *Form 17-H*

Material Associated Persons (MAP) reports, filed by registered broker-dealers. Some Hedge Fund Managers are affiliated with registered broker-dealers. MAPs generally include material affiliates and parents and may therefore include an affiliated Hedge Fund Manager or the related hedge fund. Broker-dealers must report (1) organizational chart of the broker-dealer, (2) risk management policies of the broker-dealer, (3) material legal proceedings and (4) additional financial information including aggregate positions, borrowing and off-balance sheet risk for each MAP.

The reporting requirement is triggered by status as broker or dealer registered under Section 15 of the Exchange Act.

This report is filed with the SEC quarterly and cumulatively at year-end and is not public.

There are also a variety of filings with the SEC and the securities self-regulatory organizations that must be made by registered broker-dealers and their employees who are associated persons.

Commodity Futures Trading Commission ("CFTC") and National Futures Association ("NFA")

Registered Commodity Trading Advisors ("CTAs") and Commodity Pool Operators ("CPOs")

15. *Commodity Pool Operator and Commodity Trading Advisor Registration*

An individual or entity that operates or solicits funds for a commodity pool is generally required to register as a Commodity Pool Operator. As a result, a Hedge Fund Manager may be required to register as a Commodity Pool Operator if the Hedge Fund trades futures or options on futures and the Hedge Fund Manager operates the Fund.

An individual or entity that, for compensation or profit, advises others as to the value of or advisability of buying or selling futures contracts or options on futures must generally register as a Commodity Trading Advisor unless it has provided advice to 15 or fewer persons (including each person in an advised fund or pool) in the past 12 months and does not generally hold itself out to the public as a CTA. Providing advice indirectly includes exercising trading authority over a fund or account. A Hedge Fund Manager, therefore, may also be required to register as a CTA if the related hedge fund trades futures or options on futures.

The documents required for registration as a Commodity Pool Operator or Commodity Trading Advisor are: a completed Form 7-R (which provides CPO or CTA information), a completed Form 8-R (which provides biographical data) and fingerprint card, for each principal (defined to include executive officers, directors and 10% owners), branch office manager and associated person (defined to include persons soliciting fund interests or accounts or supervising persons so engaged), and proof of passage of the "Series 3" exam for each associated person and proof of passage of the "Series 3" and futures branch office manager exams for each branch office manager.

Applications for registration are filed with and approved by the NFA under authority granted to it by the CFTC and the registration documents are generally public except for fingerprint cards, although confidentiality may be requested for certain information relating to the principals.

16. *Form 3-R amend. 7-R*

Form used to report any changes to information contained in the basic registration Form 7-R.

The requirement to file this form is triggered by changes in the information provided in Form 7-R.

The form is filed with the NFA and is public, though confidentiality may be requested for certain information relating to the principals.

17. *Form 8-T Associated Person Termination*

Form that must be filed within 20 days of the termination of an Associated Person, principal or branch manager. The form is filed with the NFA and is generally public.

18. *Ethics Examination for all Registered Persons*

Ethics training is required under CFTC Reg. §3.34 for all associated persons and any individual registered as a CPO or CTA. In connection with the annual registration update, each NFA member will receive a report indicating ethics training due or overdue for its associated persons. The member is responsible for providing proof

of ethics training to the NFA, and the NFA will confirm this information to the public.

19. *Annual Report*

Annual report of a fund that must be filed pursuant to Reg. §4.22(c) by that fund's CPO. The Annual Report must contain certain information, such as actual performance information and fees, and must be distributed to each participant in the fund.

The annual report must be filed by a registered CPO with the CFTC within 60 days of the fund's fiscal year-end and is generally publicly available; however, the CFTC is prohibited from disclosing information that would separately disclose the business transactions or market positions of any person or trade secrets or names of any investors.

20. *CPO/CTA Questionnaire*

Annual compliance questionnaire concerning its business activities for applicants registered as CPOs or CTAs. The questionnaire is filed with the NFA and is not public.

21. *NFA self-audits*

In order to satisfy their continuing supervisory responsibilities, NFA members must review their operations on an annual basis using a self-examination checklist. The checklist focuses on a member's regulatory responsibilities and solicits information on whether the member's internal procedures are adequate for meeting those responsibilities.

Registered CPOs and CTAs as members of the NFA are required to conduct such self-audit annually.

A written attestation is then signed and dated by the supervisory personnel that they have reviewed the operations in light of the checklist. This attestation is retained by the member and not forwarded to the NFA and as such is not public.

22. *Claims for exemption*

Filings made pursuant to Reg. §4.12(b)(3) (notice of claim for exemption from certain requirements by a CPO that complies with the Securities Act and manages a fund with limited trading in commodity futures and options), Reg. §4.7(a)(3) (notice of claim for exemption by a CPO with "qualified eligible participants" as investors), and Reg. §4.7(b)(3) (notice of claim for exemption by a CTA advising "qualified eligible clients"). Reg. §4.7 provides exemptions for qualifying CPO/CTO applicants from most disclosure and other requirements of CPOs and CTAs.

These statements are filed with the CFTC and NFA and are public.

23. *Disclosure Document*

CPOs and CTAs are generally required to prepare detailed Disclosure documents containing specified information. Such documents are filed with the CFTC and NFA and provided to investors but are not publicly available.

CPOs and CTAs operating under Reg. §4.7, however, are exempt from the disclosure document requirement and are required only to provide all material disclosures. In addition, under the exemption provided in Reg. §4.8, funds (which would otherwise be treated as commodity pools) with exemptions under Reg. §4.12(b) (compliance with the requirements of the Securities Act and certain limits on the trading of commodity futures and options) or which sell interests solely to "accredited investors" and rely on the safe harbor provisions of Rule 506 or 507 of Regulation D under the Securities Act may begin soliciting, accepting and receiving money upon providing the CFTC and the participants with disclosure documents for the fund, which requirement may be satisfied by a private placement memorandum.

24. *Year-End Financial Reports for §4.7 Funds*

Annual Report requirements for §4.7 funds (*i.e.,* funds, which by having only qualified eligible participants, are exempt from the normal disclosure requirements applicable to commodity pools). The form must contain a Statement of Financial Condition, a Statement of Income (Loss), appropriate footnote disclosure and other material information and a legend as to any claim made for exemption.

The annual report is filed with the CFTC, NFA and distributed to each investor, and the report is not public.

Position Reports

25. *Form 40*

"Statement of Reporting Trader" for persons who own or control reportable positions in futures. A hedge fund and/or Hedge Fund Manager will be required to file a Form 40 if it holds reportable positions. The form must be filed within ten business days following the day that a hedge fund's and/or its managers' position equals or exceeds specified levels. Such specified levels are set separately for each type of contract. For example, the reportable level for S&P 500 futures is 600 contracts. The Form 40 requires the disclosure of information about ownership and control of futures and option positions held by the reporting trader as well as the trader's use of the markets for hedging. Hedging exemptions from speculative position limits must be reported.

The form is filed with the CFTC and is not publicly available.

26. *Form 102*

Form filed by clearing members, futures commission merchants (FCMs), and foreign brokers, which identifies persons, including Hedge Funds, having financial interest in, or trading control of, special accounts in futures and options, informs the CFTC of the type of account that is being reported and gives preliminary information regarding whether positions and transactions are

commercial or noncommercial in nature. The form must be filed when the account first becomes "reportable" (i.e. when it first contains reportable futures or options positions), and updated when information concerning financial interest in, or control of, the special account changes. In addition, the form is used by exchanges to identify accounts reported through their large trader reporting systems for both futures and options.

The form is filed with the CFTC and is non-public.

Selected Stock and Futures Exchange Reports

Application for Exemption from Speculative Position Limits

27. *Spec. Position Limit Exemption*

Application filed for exemption from speculative position limits. Exchanges generally have speculative position limits for physical commodities and stock index contracts, and the CFTC has speculative position limits for agricultural commodities. Exemptions from such limits are generally available for hedging transactions. Financial contracts, such as interest rate contracts, do not have such position limits.

For example, under Rule 543 of the Chicago Mercantile Exchange ("CME"), persons intending to exceed speculative position limits on S&P 500 contracts must either file the required exemption application and receive approval prior to exceeding such limits or receive verbal approval prior to exceeding such limits and, if approved, file the required application promptly thereafter. Generally, an application for any speculative position limit exemption must show that such position is a bona fide hedging, risk management, arbitrage or spread position.

The filing is made with the appropriate exchange in the case of physical commodities and stock index contracts and with the CFTC in the case of agricultural commodities.

Federal Trade Commission ("FTC")

Filings Made Prior to Mergers and Acquisitions

28. *Hart-Scott-Rodino Notice*

Notice filed prior to the consummation of certain mergers, acquisitions and joint ventures. After notice is filed there is a waiting period while the FTC and Department of Justice review the competitive effects of the transaction. The notice includes information about the transaction and the participants in the transaction.

The notice and waiting period requirement are generally triggered by the following tests: either the acquiring person or the acquired person must be engaged in U.S. commerce or an activity affecting U.S. commerce, a person with total assets or net sales of $100 million or more is acquiring voting securities or assets of a person with total assets of $10 million or more, and as a result of the transaction, the acquiring person will hold 15% or more of the voting securities or assets of the acquired person or an aggregate of $15 million or more of assets and voting securities of the acquired person. A notice would generally have to be filed for an over $15 million purchase by a hedge fund with $100 million in assets if an exemption were not available. Acquisitions of voting securities are exempt from filing if they are made "solely for the purpose of investment" and if, as a result of the acquisition, the securities held do not exceed 10% of the outstanding voting securities of the issuer. Securities are acquired "solely for investment purposes" if the person acquiring the securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer.

The notice is filed with the FTC and the Department of Justice and is confidential.

Annex C

SOUND PRACTICES FOR HEDGE FUND MANAGERS

RECOMMENDATIONS ON VALUATION[39]

Valuation

Proper valuation is material both to Hedge Fund investors and to the risk monitoring process. Hedge Fund Managers should develop procedures for capturing and verifying prices for the instruments they trade and rely on external pricing sources where available. For Net Asset Value (NAV) purposes, Hedge Fund Managers generally should value instruments at market value, making adjustments to such values in accordance with generally accepted accounting principles ("GAAP") only where market conditions mandate adjustments, recognizing that investors will both buy and sell shares of a Fund on the basis of NAV. In contrast, Hedge Fund Managers may determine that adjustments to market value are appropriate for risk monitoring purposes in order to enhance the accuracy of risk assessment. Policies for making such adjustments should be approved by Senior Management. The concepts related to valuation are explored in greater detail in Appendix I.

Hedge Fund Managers should have pricing policies and procedures for determining a Hedge Fund's Net Asset Value (NAV) on a periodic basis and for determining the Hedge Fund's value for risk monitoring purposes on a daily basis. The policies regarding NAV determination should be approved by a Hedge Fund's Governing Authority and reviewed by external auditors for compliance with applicable accounting practices.

> Hedge Fund Managers should develop procedures and/or systems for capturing pricing data for their positions from independent sources on a daily basis where possible. Procedures for periodically verifying the accuracy of pricing data should also be adopted, and material discrepancies between price sources should be investigated. Where an instrument is not traded actively or where obtaining price information requires significant effort, weekly (or less frequent) pricing may be appropriate depending on the nature and the size of the position.

[39] The content of this Annex C is excerpted from *Sound Practices for Hedge Fund Managers* (February 2000). Capitalized terms have the meanings given to them in that document.

Net Asset Value

Senior Management should determine policies for the manner and frequency of computing NAV based upon applicable GAAP and disclose such policies to investors. Such policies should establish valuation methods that are consistent and fair to both buyers and sellers.

Financial assets and liabilities should be valued at "fair value," which is the price at which an item could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Consistent with GAAP, Senior Management should determine the valuation methods to be used where market prices are not available or are not indicative of fair value (*e.g.*, private equity investments may be valued at the lower of cost or market) and disclose such methods to a Hedge Fund's Governing Authority.

> For an instrument that is actively traded, Hedge Fund Managers should use price quotes available from reliable data vendors. The fair value of a position should be based upon the quoted price for a single trading unit in the most active market.
>
> Where price quotes are not available from data vendors, Hedge Fund Managers should attempt to obtain quotes from independent sources.
>
> For thinly traded instruments or those priced using models, Hedge Fund Managers should document the valuation methods used and periodically subject them to independent validation.
>
> Dealer quotes and prices generated by models or other estimation methods should be regularly checked against realized prices to gauge their accuracy.

NAV valuations performed by third party administrators should be regularly reviewed to ensure compliance with valuation policies.

Valuations should be periodically validated by independent internal or external review, preferably on a monthly basis, but no less frequently than annually. The accuracy of NAV calculations should be verified by external auditors at least annually to assure compliance with GAAP.

Risk Monitoring Valuation

Senior Management should establish policies for determining when risk monitoring valuation methods may differ from NAV for operational or risk analysis reasons. Examples where valuations different from NAV may

be appropriate include situations such as those involving unusual position size, legal sale or transfer restrictions, illiquidity, control premiums or unusual hedging or transaction costs.

The following is an excerpt from Appendix I of *Sound Practices for Hedge Fund Managers*:

Valuation

As noted in the Recommendations, the valuation of positions serves two distinct purposes for the Hedge Fund Manager. In addition to providing the base input to the risk monitoring process, valuation of positions is required for the calculation of Net Asset Value (NAV), which is the basis for investor subscriptions and redemptions.

Hedge Fund Managers' valuation policies should be objective, fair, and consistent.

- Objectivity requires that Hedge Fund Managers either calculate or verify the accuracy of prices independent of the trading/risk selection function. To that end, Hedge Fund Managers should look to reliable price quotes from external sources wherever possible and cost effective to do so.
- Fairness recognizes that valuation for NAV purposes will determine the prices at which investors subscribe to or redeem from the Fund.
- Consistency can be achieved through the establishment of recognized procedures or practices. This section will provide more detail on valuation issues than was provided in the Recommendations, particularly with respect to valuation for risk monitoring purposes. After restating the principles of NAV valuation, Price Sources and Price Validation will be reviewed. Then, the discussion turns to valuation for risk monitoring purposes.

Net Asset Valuation

Fair Value. As described in the Recommendations, for NAV purposes, Hedge Fund Managers generally should value instruments according to generally accepted accounting principles (GAAP) for the appropriate jurisdiction, recognizing that investors will both buy and sell shares of a Fund on the basis of NAV and that its financial statements must reflect NAV. This generally requires the use of "fair value". For example, under FASB Statement of Financial Accounting Standards No. 107, the "fair value" of financial assets and liabilities under U.S. GAAP is the amount at which the item could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Calculation of NAV must take into account not only the value of the financial instruments in the portfolio (sometimes referred to as "trading P&L"), but also accruals of interest, dividends and other receivables and fees, expenses and other payables.

Prices. Where market prices exist and are indicative of fair value, they should generally be used to compute NAV. For instruments that are actively traded, the fair value should be the product of the number of trading units times the quoted price for a single trading unit in the most active market, even if placing an order to sell (or buy, if short) the holding might affect the price if a market's normal one-day volume might not be sufficient to absorb the quantity held.

For instruments traded in the over-the-counter market, Hedge Fund Managers should, to the extent possible, attempt to obtain multiple quotes from dealers active in that market. Where appropriate, the model parameters that the dealer used in determining its valuation should be obtained and analyzed.

Further considerations on price data are discussed below under "Price Sources".

Senior Management should establish the valuation methods to be used for NAV purposes where market prices do not exist or are not indicative of fair value. These methods should be disclosed to a Hedge Fund's Governing Authority. For investments in non-traded assets or assets that are extremely illiquid or otherwise difficult to value, Hedge Fund Managers should document the valuation methods used and periodically subject them to independent validation. For example, because there are no objective external price references for private equity investments, Hedge Fund Managers may determine they should be carried at historical cost.[40]

Frequency. Senior Management should determine the frequency of computing NAV, which will be needed on each date for which balance sheets are prepared and each interim date on which NAV is disclosed to the Governing Authority or investors. Some Hedge Fund Managers calculate a daily NAV, while others calculate NAV less frequently.

If initial end-of-day values for portfolio instruments are obtained from the Hedge Fund Manager's trader or other front-office staff, such values should be verified with a frequency determined by the materiality of the position. Significant differences between front- and back-office valuations should be investigated and reconciled. Alternatively, end-of-day valuation may be exclusively the role of back-office staff.

Portfolio values used to calculate NAV should also be used for risk monitoring valuation, except as expressly determined otherwise by Senior Management due to operational or risk analysis reasons as discussed below under "Valuation for Risk Monitoring". However, valuation for risk monitoring purposes will be performed daily even though NAV may be calculated less frequently. Also, the daily expense accruals that must be reflected in NAV are generally not included in the portfolio valuation for Risk Monitoring purposes, which is instead based on the concept of trading P&L.

Price Sources

The appropriate source of price data depends on the position in question:

- Many of the positions held by Hedge Funds are securities or derivatives that are listed on organized exchanges or in over-the-counter markets for which reliable price

[40] Since illiquid instruments with long holding periods will generally not be included in the daily risk monitoring model, valuing these instruments on a daily basis for Risk Monitoring is not necessary.

quotes can be obtained from third-party data vendors. For those securities and derivatives, fair value can be based on the "closing" quotation or official closing price of an exchange or prices in the OTC market or other 24-hour markets as they appear on a data vendor screen (observed at the same time on each day).

- Data vendors may also provide quotations for less actively traded instruments based on a method known as "matrix pricing." Matrix pricing uses market quotes for actively traded securities to approximate the value of a less actively traded security based on comparable characteristics, such as coupon, maturity, and risk. Matrix prices can be a useful source of third-party price information, but they should be recognized as modeled prices not transaction prices.
- Reliable quotes for certain over-the-counter derivative instruments and structured securities may not be available from data vendors, either because the transactions are "one of a kind" or not actively traded. In many cases the only "market" for these securities is with the original counterparty to the transaction. Such instruments can be valued either by obtaining a quote from the originating counterparty or from a pricing model. While a Hedge Fund Manager might be able to obtain quotes from other dealers not party to the original transaction (which would provide a more independent source of pricing information), such an approach may not be practical, for example because it would require disclosure of proprietary position data.

Price Validation

- Hedge Fund Managers should establish procedures for verifying the accuracy of prices obtained from data vendors, dealers, or other sources. For actively traded instruments, it may be sufficient to establish multiple feeds from data vendors in order to compare and verify their prices. In other cases, the Hedge Fund Manager should establish procedures for verifying the inputs to models and for validating modeled prices. Modeled prices could be validated by comparing them to prices observed in the market or to prices obtained from third parties where possible. As noted in the Recommendations, dealer quotes and prices generated by models or other estimation methods also should be regularly checked against realized prices to gauge their accuracy. Hedge Fund Managers may elect to use external auditors to verify aspects of their pricing and modeling, either as part of an annual audit or an independent review.

Valuation is typically independent of the trading function. However, for certain illiquid or hard to value investments, such as private equity investments, the valuation process may *begin* with a price obtained from those most familiar with a particular position, i.e., the trader or analyst. However, in such situations, the Hedge Fund Manager should take steps to independently (either internally or externally as appropriate) assess the reasonableness of that price.

Valuation for Risk Monitoring

The Risk Monitoring Function typically values positions consistent with the approach taken for the NAV calculation. However, the Risk Monitoring Function is not constrained by the requirements of GAAP. Consequently, in order to examine potential effects on the portfolio of changes in market conditions, the Risk Monitoring Function may use alternative values or may make adjustments to the position values calculated for NAV purposes. Senior Management should establish policies for determining when risk management valuation methods may differ from NAV for operational or risk analysis reasons. It would not be appropriate, however, to adjust a long position upward or a short position downward, from its fair value for Risk Monitoring purposes.

- Rather than using mid-market prices, bid prices could be used for long positions and ask prices used for short positions.
- Prices may be discounted to reflect the size of a position relative to the market, for example by using "exit values" rather than fair value. Exit value reflects the likely impact on the market price where the position must be liquidated quickly, such as where the position is significantly larger than historical trading volume during the assumed required exit period.
- For an actively traded security held in a large enough quantity and/or involving sufficient indicia of control that a Schedule 13D or similar public disclosure has been made of the position, and therefore where a sale of a portion could not be made anonymously, a downward adjustment from market value may be appropriate.
- For instruments subject to legal restrictions on sale or where the market is illiquid or has become disorderly, it may be appropriate to make a downward adjustment from the fair value.
- In volatile markets, prices may be discounted if the Risk Monitoring Function does not believe that quoted bids or offers are prices at which a trade could actually be done.
- For a less actively traded instrument representing only a small position, and where obtaining price information requires significant effort, weekly (or even less frequent) pricing may be appropriate.